Dist.
GENERAL

UNCTAD/GID/16
17 July 1995

English only

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

FINANCING SMALL AND MEDIUM ENTERPRISES IN LATIN AMERICA

by Professor Clemente Ruiz-Durán*
Universidad Nacional Autonoma de México

---

*The views expressed in this report are those of the author. The report is circulated in the form and language in which it was received.

GE.95-52342

CONTENTS

Chapter I. SME and the development of the domestic economy . . . . . Page 3

A. What is small? . . . . . Page 3

B. Contribution to the domestic economy . . . . . Page 4

B.1 Small businesses as a source of entrepreneurship . . . . . Page 4

B.2 Small businesses and employment in LA . . . . . Page 5

B.3 Productivity puzzle or the value added problem . . . . . Page 6

B.4 SME savings and accumulation . . . . . Page 7

B.5 SME and Social Security . . . . . Page 7

C. SMEs and domestic industrial organization . . . . . Page 9

C.1 Export or domestic market . . . . . Page 10

C.2 Economies of agglomeration in Latin America . . . . . Page 11

C.3 Subcontracting or the move toward a network economy . . . Page 12

Chapter II. Financing of small enterprises in Latin America . . . . . Page 14

A. Capital structure puzzle . . . . . Page 14

B. Institutional framework or the origin of credit restrictions . Page 18

B.1 Stock and money market . . . . . Page 18

B.2 Banking and non banking finance . . . . . Page 18

C. Informal finance . . . . . Page 26

C.1 Rotating savings and credit associations . . . . . Page 28

C.2 Informal savings banks, moneylenders and the short term credit paradigm . . . . . Page 28

C.3 Non-governmental organizations and the finance of SME . . Page 29

D. Problems of access by SMEs to formal sector finance . . . . . Page 29

Chapter III. Measures to improve SME's access to financing . . . . . Page 35

A. Government measures to support SME's financing . . . . . Page 35

B. What is the basic problem? . . . . . Page 37

C. How to reform the financial system as to improve access of SME? . . . . . Page 37

Bibliography . . . . . Page 39

Annexes . . . . . Page 43

Chapter I
SME and the development of the domestic economy

A. What is small?

The definition of a small enterprise varies from region to region, and from country to country. In Latin America, a small firm is generally defined by the number of its employees but some countries have chosen sales or assets to define the size of the firm. Definitions of micro and small firms are more or less homogenous in all countries, except in Brazil and Mexico where the limit is 100 employees for defining smallness. In Guatemala, Peru and Uruguay the limit is 19 employees. In some countries (e.g. Uruguay) medium size enterprises are defined as having more than 20 employees and in others more than 100. Large firms are defined as having 50 employees in Guatemala and 500 in Brazil.

Table 1

Size business definition by number of employees

	Micro	Small	Medium	Large
Argentina	less than 15	16-50	51-200	above 200
Bolivia	less than 5	5-49	50-99	above 100
Brazil	less than 19	20-99	100-499	above 500
Chile	less than 1-9	10-49	50-200	above 200
Colombia	less than 10	10-49	50-199	above 200
Ecuador	less than 10	10-49	50-99	above 100
Guatemala	less than 2-8	5-19	20-50	above 50
Mexico	less than 15	16-100	101-250	above 250
Peru	less than 5	5-19	20-199	above 200
Uruguay	less than 4	5-19	20-99	above 99

Sources: **Argentina:** Francisco Gatto, Las PYMES en el MERCOSUR, CEPAL, 1993, just for the industrial sector. **Bolivia:** Brigitte Spath, Small firms and development in L.A., International Institute of Labor Studies. **Brazil:** Las PYMES en el MERCOSUR, CEPAL, 1993, SEBRAE. **Colombia:** Pinto y Arango, La pequeña y mediana industria en Colombia. **Chile:** Programa Nacional de Apoyo a la pequeña y Mediana Empresa 1992-1993, Ministerio de Economía, is not an official classification, just for analytical purposes. **Ecuador:** Coorporación financiera Nacional, Ley de Fomento a la pequeña Industria y Artesanía (Micro is not included). **Guatemala:** Arturo Padilla, La pequeña y Mediana empresa en Guatemala, CEPAL, 1994. In some cases the micro industry is a subgroup for the small industry. **Mexico:** Secretaría de Comercio y Fomento Industrial, Diario Ofical del 3 de diciembre de 1993. **Peru:** Fernando Vallarán, Small scale industry and efficiency groups in Peru. Small firms and development in L.A., International Institute of Labor Studies. **Uruguay:** Francisco Gatto, Las PYMES en el MERCOSUR, CEPAL, 1993.

Most countries find it necessary to have a second or third parameter to define smallness, and for that purpose they also use the level of sales, net income, assets, and equity.[1]

A comparative analysis between countries should take into account the diversity of definitions. It should also take into consideration the fact that definitions often reflect the level of development not only of the country itself, but also of entrepreneurship.

[1] Annex 1

B. Contribution to the domestic economy

The development strategy in Latin American countries has heavily relied on large enterprises. This strategy was guided by the idea that only large scale production, capital intensity and modern technology could lead to an integrated industrial development. The idea that small enterprises might be the key to economic dynamics and employment growth may have seemed eccentric or even absurd. Today, this view seems much less far fetched. On the contrary, almost all economic forces in Latin America embrace the idea that small businesses are strategic for sustainable growth. Moreover, the integration between large and small enterprises is seen as giving these economies a competitive edge in the globalized economy.

Table 2

Size business definition by a second parameter*

	Parameter	Micro	Small	Medium	Large
Argentina	Sales	less than 200	200-1,260	1,260-12,800	above 12,800
	Assets	less than 100	100-600	600-4,400	
Brazil	Net income	less than 130	130-1,300	1,300-4,000	above 4,400
Chile	Sales	less than 60	60-600	600-1,200	above 4,000
Ecuador	Assets, without land and buildings	less than 6	less than 52		above 1,200
Guatemala	Equity**	less than 338-5932	Up to 12,711	Up to 33,898	above 33,898
Mexico	Sales	less than 180	180-1,800	1,800-20,000	above 20,000
Uruguay	Sales	less than 60	60-180	180-1,000	above 1,000
	Assets	less than 20	20-50	50-350	above 350

*In thousands of US dollars, using current exchange rates to convert national currencies into US dollars
**Guatemala data are in US dollars not in thousands

Sources: **Argentina:** Francisco Gatto, Las PYMES en el MERCOSUR, CEPAL, 1993, just for the industrial sector. **Brazil:** Las PYMES en el MERCOSUR, CEPAL, 1993, SEBRAE. **Colombia:** Pinto y Arango, La pequeña y mediana industria en Colombia. **Chile:** Programa Nacional de Apoyo a la pequeña y Mediana Empresa 1992-1993, Ministerio de Economía, is not an official classification, just for analytical purposes. **Ecuador:** Coorporación financiera Nacional, Ley de Fomento a la pequeña Industria y Artesania (Micro is not included). **Guatemala:** Arturo Padilla, La pequeña y Mediana empresa en Guatemala, CEPAL, 1994. In some cases the micro industry is a subgroup for the small industry. **Mexico:** Secretaria de Comercio y Fomento Industrial, Diario Ofical del 3 de diciembre de 1993. **Peru:** Fernando Vallarán, Small scale industry and efficiency groups in Peru. Small firms and development in L.A., International Institute of Labor Studies. **Uruguay:** Francisco Gatto, Las PYMES en el MERCOSUR, CEPAL, 1993.

B.1. Small businesses as a source of entrepreneurship

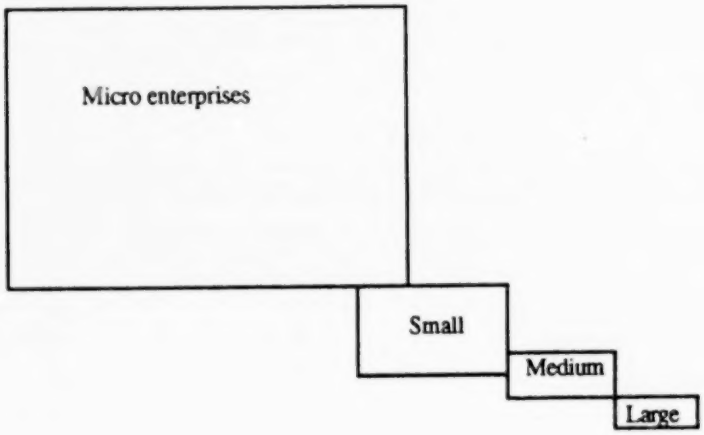
At the turn of the century, small businesses became an important factor in the world economy, both in terms of its contribution to growth and to employment creation. Small enterprises are a key factor of change, and in Latin America they also played a major role as a source of entrepreneurship. In Colombia, out of 94 thousand industrial enterprises, 89 per cent are micro, 6 per cent small, 4 per cent medium size and 1 per cent large business. In Chile, out of 465 thousand enterprises, 83 per cent are micro, 14 per cent are small, 1.2 per cent are medium and 1.5 per cent large; in Brazil out of 186 thousand industrial businesses, 82 per cent are micro, 13 per cent small, 4 per cent medium and 1 per cent large; in Peru out of 159 thousand establishments, 87.5 per cent are micro, 10.8 per cent small, 1.5 medium and 0.1 per cent large; in Ecuador of the 1523 industrial businesses, 67 per cent are small, 16 per cent medium and 17 per cent large; in

Bolivia out of 11 thousand industrial businesses, 87.2 per cent are micro, 8.3 per cent small, 2.3 per cent medium and 2.3 per cent large; in Mexico, out of 266,033 establishments, 92 per cent are micro; 6 per cent small, 1 per cent medium and 1 per cent large.[2]

The above statistics show tnat the business sector in Latin America is dominated by micro and small enterprises, with a very low share of medium and large enterprises. This result could be considered as an entrepreneurship response to the lack of employment from other sources, i.e. large enterprises and the government.

B.2. Small businesses and employment in LA

One of the most important features of small business in Latin America has been its employment generation role. For example, in Mexico during the period 1988-1993, small businesses (1-100 workers) provided 58.8 per cent of new jobs, medium sized enterprises (101-300 workers) 15.9 per cent, and large (more than 300 workers) 25.3 per cent.[3] In other Latin American countries a similar situation can be observed: in Colombia, SMEs provide 47 per cent of industrial employment; in Brazil 40 per cent; in Peru 71 per cent; in Bolivia 44 per cent; in Ecuador 21 per cent; and in Chile small and medium enterprises account for 90 per cent of total employment.[4]



The role of small businesses in the labor market has changed the traditional development paradigm, where the major providers of new jobs were large enterprises. It is worthwhile to analyze how this change has occurred. Although big businesses create a larger amount of employment initially, small enterprise proliferation provides a larger amount of new jobs in the long run.

During the last ten years in Mexico, 80 new big industrial enterprises were created, but the number of employees in big firms decreased by 307,000. During the same period the number of small businesses increased by 131,000 which created 339,000 new jobs. Although small businesses had become a safety net for employment, it shall be commented that the average multiplier of these new establishments was as low as 3 employees per establishment. Moreover, the expansion of micro businesses requires a very low capital ratio. This means that

---

[2] Annex table SME.2

[3] INEGI, Censos Industriales 1989, 1984.

[4] Annex table SME.3

in money terms it is cheaper to create new jobs in small businesses than in the big ones. Thus the amount of investment required to create a new job in a large business is higher than in a small business.

In Mexico, the amount of investment required to create a new job in a small business was around 11,000 dollars in 1989, while in a big business it was around 50,000 dollars. It can be argued that small businesses are a more efficient source of new employment and that they could be a key factor in the design of new employment policies for Latin American economies.[5]

B.3. Productivity puzzle or the value added problem

The importance of small businesses in employment creation is diminished when one considers value added. In Mexico, businesses of up to 100 employees account for 21 per cent of industrial value added, in Bolivia 11 per cent, in Ecuador 13 per cent, in Brazil 22 per cent, in Chile 19 per cent, in Colombia 30 per cent and in Peru 26 per cent. This low share is linked to manufacturing activities that SMEs are involved in (i.e. food, beverage, tobacco, textiles and furniture etc.), which explains their low productivity when compared to large enterprises. A comparison of value added by employee in the manufacturing sector in Latin American countries yields the following results: in Colombia the valued added by employee in large enterprises is four times higher than in micro businesses; in Peru it is fourteen times higher; in Bolivia seven times higher and in Mexico five times higher. The average productivity among countries also varies considerably, being the largest in Chile. A larger value added is a reflection of a more sophisticated manufacturing industry. Thus, it is not only the number of small firms which is important, but also how they are organized and what they produce.

Table 3

Index of manufacturing value added by employee and by firm size

Country	*Definition*	*Micro*	*Small*	*Medium*	*Large*	%
Brazil 1985		29	71	111	164	100,0
Colombia (a) 1990	Total income	35	92	92	148	100,0
Chile (b) 1992	Total sales	11	38		372	100,0
Peru (c) 1987	Value added	25	68	175	360	100,0
Ecuador (d) 1989	Value added	-	62	98	113	100,0
Bolivia (e) 1992	Value added	27	16	34	193	100,0
México (f) 1994	Net income	44	65	83	147	100,0

Sources and definitions
(a) Colombia: CEPAL Las Pymes en el mercosur. Micro 0-10; small 10-49; medium 50-199; large >200 employees
(b) Chile Ministerio de Economia Micro 0-$60 mil; small $60 mil-$600 mil; medium 5$600 mil-1.2 mil; large > 1.2 million
(c) Brazil Small firms in Latin America Micro 0-19; small 20-99; medium 100-499; large >500 employees
(d) Peru Small firms in Latin America Micro 0-4; small 5-19; medium 20-199; large >200 employees
(e) Ecuador BID Diagnostico de la Pequeña y Mediana Industria en el Ecuador Small 10-49; medium 50-99; large >100 employees
(f) Ceres La Pequeña y Mediana empresa en Bolivia Micro 1-4; small 5-15; medium 15-29; large >30
(g) INEGI Censos Economicos 1994 Micro 0-15; small 16-100; medium 101-250; large >250

Low productivity limits growth, since the income generated is so small that it allows subsistence, but doesn't enable growth and accumulation. This sort of situation can be called the value added trap.

In almost all countries of the region the share of food, beverages and tobacco, and textiles is around 50 per cent of the economic units involved, 36 to 46 of employment, and 34 to 46 of value added or of gross production. Average level of value added (in US dollars) for these activities is very low: in Mexico

[5] Ruiz Durán Clemente. Economia de la Pequeña Empresa (Ariel Editorial, 1995).

it amounts to US$4500 per employee in the food sector and of US$8000 per employee in the textile industry; and figures are similar in Ecuador, with US$6400 per employee in the food sector and of US$3300 per employee in the textile industry. Another area where there is a large share for SMEs is machinery and equipment with SMEs accounting for 15 per cent of economic units, and between 16 to 20 per cent of employment and value added (gross production). The activities that small business is developing in this area are concentrated in the sector of metal products, with a very low net income or value added which is equivalent to around US$4800 per employee in Ecuador and around US$8200 in Mexico. The share of SMEs in areas of high value added is low, i.e. plastics or basic metal, and it could be explained by the fact that they require higher levels of capital, limiting, thus, the growth of SME in those sectors.

B.4. SME savings and accumulation

The economic analysis of SMEs based on the use of macro variables usually ignored the disagreggation of savings by size of enterprise, since the assumption was that large businesses are the dominant factor affecting aggregate savings. Although that could be true for a static analysis, what is important for long run accumulation is the ratio of reinvested profits. Therefore, what should be estimated is not the SME contribution to the level of savings itself, but the marginal savings rate. Theoretically, the marginal savings rate is expected to be higher in SMEs than in large businesses; a corporate organization forces the distribution of profits among associates, whereas in a small business, entrepreneurs will prefer to reinvest their profits. This can be expressed by the following equation.

$$BS = BS_L + BS_{SME} = b_L PR_L + D_L + b_{SME} PR_{SME} + D_{SME}$$

where:
BS: business savings
PR: total profit
b: part of profit which is reinvested
D: depreciation
L: large business
SME: small and medium business

All b coefficients are greater than zero; $b_{SME} > b_L$ postulates that the reinvestment ratio is higher in SMEs than in corporate businesses. A survey realized in 1,035 micro and small firms in Mexico (op.cit.) during the period 1992-1994, gives a better understanding of the savings behavior of entrepreneurs.

The average level of sales of the firms surveyed amounted to US$368,000 a year. They had the following cost structure: raw materials (38 per cent), labor (23 per cent), taxes (9 per cent), energy (8 per cent), leasing and interests (7 per cent), depreciation (4 per cent) and other costs (11 per cent). After deducting costs from sales, average profits were 19 per cent of sales. Gross profits were around US$68,000.

To get a value for b_{SME}, a proxy can be used as long as it is known how SME entrepreneurs spend their profits. The survey indicates that they were spent as follows: machinery and equipment (49 per cent), expansion of facilities (21 per cent), entrepreneur expenditures (15 per cent) and other expenditures (15 per cent). It can be assumed that expenditures on machinery, equipment, and expansion of facilities are reinvested profits, so the average value of reinvestment for this sample is 0.7. This is higher than the average μ for corporate businesses in the stock market, which is of 0.5. These results support the view that marginal savings of SMEs are larger than those of corporate businesses.

B.5. SME and Social Security

Compulsory contributions to social security are another channel through which SMEs contribute to domestic savings. Latin American countries had a tradition for imposing high rates to all businesses, which is different from the

practice in developed economies where different rates of contribution are set according to the size of the business. Taking that into consideration, the burden of social security is higher for SMEs than for the corporate sector. The range of the social security tax ranges from 0.9 per cent in Chile, to 33 per cent in Argentina.

In addition, we find that SMEs are one of the largest contributors to social security in Peru the share of SMEs in the number of establishments of registered business for social security is of 66 per cent of total, 10 per cent in terms of employment, but only 4 per cent of contributions.

Table 4

SME share in manufacturing sectors

	Bolivia		Ecuador			Mexico			Mercosur*	
	Units	Emply't	Units	Emply't	Value Added	Units	Emply't	Net Income	Emply't	Gross Production
Food, beverages	24.1	25.0	24.4	24.5	32.7	34.7	23.1	22.1	13.5	19.4
Textiles	26.8	21.4	19.0	19.9	13.7	16.6	19.6	12.2	22.9	19.6
Wood	18.2	17.2	7.6	6.9	3.3	11.9	8.1	4.5	8.9	6.2
Paper	3.9	5.7	7.5	6.3	5.4	5.6	7.7	8.4	5.9	5.5
Chemicals	1.8	4.8	15.4	16.8	21.3	10.7	13.0	24.5	11.7	12.2
Plastics	4.1	6.0	6.6	6.2	3.1	1.2	4.6	4.5	3.8	4.1
Basic metal	0.1	0.3	0.9	1.3	2.5	0.1	0.9	1.9	10.2	10.1
Machinery and equipment	15.3	16.1	17.0	16.4	16.5	17.4	21.4	20.9	20.1	18.0
Others	5.5	3.6	1.7	1.7	1.5	1.8	1.7	1.0	3.4	4.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.00

*Mercosur includes: Argentina, Brazil and Uruguay

Sources: Gatto F., Ferraro C., Las PYMES en el Mercosur, INEGI Censos Economicos 1994, México.

In Mexico SME establishments are 98 per cent of registered business to social security, employment is half of total employment and contributions are almost 40 per cent of total. The above data shows a very heterogeneous situation regarding compulsory contributions, due to the composition of the SME sector in each country, and related to labor intensity, or capital intensity. A negative effect of high social security taxes is that induces a reversal in the use of labor, toward more capital intensity , affecting employment. So it can be argued that government policy hits the employment decision or formality through the social security tax, that could be avoided if instead of a compulsory tax over business it is replaced to be financed by general taxes. The above discussion shows that voluntary and involuntary savings are high in SME, that is a change from the traditional assumption that this size of businesses doesn't contribute to savings. Not only that, but it can be argued, that savings rates are higher for small enterprises than for corporate businesses.

Table 5

Social Security Employer contributions as % of payroll

Country	Contribution (%)
Ecuador	9.0
Bolivia	15.0
Colombia	14.5-17.8
Mexico	25.2
Argentina	33.0
Chile	0.9
Brazil	18.2-20.7
Guatemala	10.0

Source: Mesa-Lago. El progreso Economico y Social en América Latina
Mesa-Lago. Social Security and Prospects for Equity in L.A. 1991
Ruiz Durán et.a. Sistemas de Bienestar Social en Norteamérica 1994

Table 6

SMEs Social Security Contributions as % of total contributions in Peru

	SMEs	Large	Total
Establishment share	66	33	100
Employee share	10	90	100
Contributions	4	96	100

Source: Mesa-Lago. Social Security and Prospects for Equity in L.A.
SMEs 1-6; large more than 6

Table 7

SMEs Social Security Contributions as % of total contributions in Mexico

	Small	Medium	Large	Total
Establishment share	96.1	1.9	2.0	100.0
Employee share	38.6	10.0	51.4	100.0
Contributions	28.4	10.3	61.3	100.0

Source: Instituto Mexicano del Seguro Social
Small 0-50; medium 51-100; large > 100

C. SMEs and domestic industrial organization

Industrial organization in Latin America has relied on large firms in the big countries (Argentina, Brazil, Chile, Colombia, Venezuela and Mexico), while smaller countries (Bolivia, Ecuador, Peru, Paraguay, Uruguay, Central America) relied on small firms. In big countries, transnational corporations tended to focus on manufacturing activities, whereas in the smaller countries, transnationals engaged in primary activities or services. Large firms can be mostly found in the modern sector of the economy and SMEs have played the role of an employment safety net.

Such an organizational structure helps to explain why a large number of SMEs are in the informal sector of the economy. Latin American governments have allowed the existence of this sector to avoid social conflict. However, a problem with the informal sector is that it reduces state control over the economy, and the emergence of parallel power agreements reduces the effectiveness of economic policy. In Mexico, the informal sector accounts for one third of employment and one tenth of GDP (STPS 1994), and in Colombia for more than 50 per cent of total employment (CIE 1986).

Microenterprises are in many cases in the informal sector, due to the large number of procedures that are required to register. Tokman (1991) researched how many administrative steps were required for registration an found that the main obstacles for entering the formal sector of the economy were:

1. Time involved in filling all the registration requirements.
2. High financial cost of entry.
3. It is more costly to legalize activities in manufacturing.

Regulations could either be seen as an obstacle to entrepreneurship or as a badly designed government mechanism for protecting different social groups. In

the case of social security, instead of it being financed by general taxation, it depends on specific fees charged to businesses, thus increasing the tax burden and acting as an obstacle to the growth of employment in the formal sector; general taxes would have been a better way to protect different social groups.

SME activities can be grouped in five areas:

1. **Linked to demographic growth**. In this group we find SMEs that respond to demand growth generated by the population expansion which is expected to continue growing at 1.5-2 per cent a year up to the year 2000. A typical demographic oriented.

2. **Traditional technology enterprises**, are those where technological change has not taken place and for which expansion is linked to basic consumption goods, (such as the textile industry which did not develop new designs and produces low quality garments). This group accounts for around one fifth of all SMEs.

3. **Forced innovation enterprises**. Businesses that due to the debt crisis were provided with an opportunity to develop new products that substituted imports, (examples can be found in the metal mechanic industry).

4. **Enterprises linked to export dynamics**. This subgroup is comprised of more dynamic firms, which were able to market their products directly or indirectly in foreign markets.

5. **Enterprises without restructuring capacity,** are those linked to subsistence demand.

Groups 1 and 2 (i.e. food, textile and wood) account for around half of all SMEs in industry. Innovative and export oriented firms are in various sectors, and are the ones that could help to spur economic growth in many countries of the region and allow for a more integrated productive structure.

Table 8

Administrative steps required for registration (number)

	Initial Registration	Location	Health and Security	Taxes	Labor	Total of Steps	No. of working days to open a manufacturing business
Bolivia	4	-	-	1	-	5	15-30
Brazil	6	3	3	10	-	22	44
Chile	4	10	4	5	-	23	65
Ecuador	39	-	5	7	9	60	180-240
Guatemala	4	-	-	22	5	31	525
Mexico	16	2	1	2	-	21	83-240
Uruguay	5	2	1	1	4	13	75-90
Venezuela	13	-	5	5	5	28	170-310

Source: Standing Guy, Tokman Victor, Towards Social Adjustment, ILO, 1991

C.1. Export or domestic market. For a long time SMEs did not face a dilemma where to sell their products. Their production was so small that it was absorbed by the domestic market at higher prices that in the export market. This process continued until the crisis in the early eighties. The debt crisis and the subsequent economic restructuring in most Latin America countries during the past decade forced an industrial reorganization and pushed domestic firms to operate in more competitive conditions. Trade and other forms of liberalization were viewed in Latin America with a wide range of expectations, from the very optimistic to the quite pessimistic. On the one hand, since most past

interventions were seen as benefiting larger enterprises, more perfect input and output markets may be viewed as helping such firms to achieve their potential. Yet in a number of countries of Latin America there is considerable concern that SMEs will suffer heavily from import competition and will not be able at the same time to move effectively into export activities.

Available evidence on how SMEs are likely to respond to liberalization in Latin America and what policies might most contribute to a good response is very limited. The process itself is too recent in most countries for one to have even a clear picture of what is happening or to understand much about the mechanisms which may be at work. However, recent census data in Mexico might be helpful for understanding the behavior of SMEs in the period 1988-1993 when the opening of the economy took place. There was concern that there was going to be a large destruction of manufacturing firms, specially SMEs. Census data shows that their behavior was better than expected. The number of SMEs increased by 127 thousand and they were the main source of new jobs for the same period. In the Mexican survey when entrepreneurs were asked how the opening had affected them, their answers were: sales reduction (43 per cent); no change (30 per cent); sales increase (10 per cent); forced the use of more sophisticated technology (9 per cent).

C.2. Economies of agglomeration in Latin America. One of the main factors constraining the growth of SMEs has been the lack of geographical concentration and small scale production both of which increased transaction costs. The agglomeration of many firms operating in the same industry and in a geographically limited area tends to reduce transport costs and other operation costs. The proximity of manufacturing firms specialized in the various phases of the same production cycle tends to lower transport costs for goods and semi-finished products. Geographical concentration could help SMEs to reduce costs, and cooperation among firms based on the Italian model (industrial district concept) could reduce transactions costs.

Regional development in Latin America has been uneven, with a trend towards concentration in large metropolitan areas. In a megalopolis individual firms remain isolated, and only a few cases can be found where there has been a move towards integration to get advantage of joint purchases or marketing. In Ecuador two provinces, Pichincha and Guayas, (where the largest two megalopolis have been developed) host almost three fourths of all SMEs, in Mexico one third of SMEs are around Mexico city, in Bolivia three departments (La Paz, Cochamba and Santa Cruz) account for three fourths of all SMEs, and in Colombia almost all SMEs can be found in four cities (Bogota, Cali, Medellin and Barranquilla).

Although concentration has not supported the development of an industrial district paradigm as in Italy, there are some dynamic groups that have been able to build cooperative schemes. In Mexico, there was an open promotion of what was called "empresas integradoras" during the 1988-1994 Administration, creating 90 cooperatives schemes among SMEs in different sectors and regions of the country (Salinas 1994). Non-government agencies in the rest of Latin America also promote the idea of cooperation among SMEs and have been successful at the artisan level. Villarán (1993) describes some of the successful association stories around metropolitan areas of Peru, (like the Complejo Gamarra) where a conglomerate of micro, small and medium enterprises for marketing clothing and fashion wear developed; also, a consortium to promote the capital goods industry (CBK), was created, comprising 30 small and medium-sized firms in the metallurgy industry. Although these firms do not share a common geographical area, they have created a very solid organization which enables them to adopt a collective approach to a series of jobs. Another example is the Trujillo Footwear Manufactures, where according to estimates, there are 1,000 small-scale and micro firms manufacturing footwear, including a number of tanneries and materials manufacturers, clustering mainly in El Porvenir district of the city of Trujillo.

Some of these cases show that there is a trend toward greater association among SMEs in the regions. However, it is not yet possible to talk of a well organized approach towards integration, but there are some experiences that are encouraging. Individual firms are realizing that they face large costs if they remain isolated. So, it can be expected that there will be a move toward tighter

cooperation in the region, either through government incentives or as a response of individual firms to the need for greater competitiveness.

C.3 Subcontracting or the move toward a network economy[6]

The search for productive integration in Latin America has changed over time. At the beginning, backward linkages amongst large firms were thought to be the best way to achieve an integrated economic structure. The emergence of flexible production during the seventies and eighties, led to a new approach. Efforts were aimed at developing subcontracting among large and small firms, and governments decided to create what was called "bancos de subcontratación" and finance individual efforts in the subcontracting area.

There is no comprehensive analysis of this subject. However, the surveys carried out by Kagami-Ruiz-Schwartz show that even SMEs which sell their products mainly in the domestic market are actively involved in subcontracting activities. According to the survey, 42 per cent of SMEs in Brazil were engaged in subcontracting in one form or another, either out-sourcing, producing or both. In Mexico 35 per cent of enterprises were engaged in subcontracting, but the average was 50 per cent in Mexico City and 14 per cent in the Gulf region. The range of subcontracting varied among firms, but it has increased over time.

Firms stated the following reasons for their decision to subcontract: sales increased (42 per cent); mutual cooperation (19 per cent); operation stabilization (18 per cent) and as request of head-office (13 per cent). In subcontracting operations SMEs were supported by large firms through: providing raw materials (42 per cent); technical assistance (15.6 per cent); financial assistance (9.4 per cent); capital goods (8.7 per cent) and none (18 per cent).

SMEs stated that subcontracting has allowed them to diversify the line of production (48 per cent); improve product quality (33 per cent) and develop new products (19 per cent). They were selected by their counterparts due to: quality and design (69 per cent); low prices (20 per cent); and personal relations (10 per cent). Only 10 per cent of firms stated that they had a bad relation with their counterparts, 56 per cent stated that it was regular and 34 per cent that it was correct.

The subcontracting outlook was moderate for 42 per cent of firms, good for 37 per cent, and not that good for 21 per cent of firms. Almost all firms were sure they will continue subcontracting (84 per cent).

Comparing SMEs that subcontracted and those that did not, the following conclusions emerged:

1. The working capital is larger in subcontracting firms (132 thousand dollars) than in those that do not engage in subcontracting (126 thousand dollars).

2. Average number of employees in subcontracting firms (18 employees) is larger than the average in the Census firms (5 employees).

3. Sales levels are higher in non subcontracting firms (312 thousand dollars) that in subcontracting firms (267 thousand dollars).

4. Subcontracting firms have a higher profit ratio (21 per cent) than non- subcontracting firms (20 per cent) and have a larger reinvestment ratio in capital goods (47 vs. 38 per cent).

5. Entrepreneurs that subcontract have a better educational profile than non subcontracting entrepreneurs. Eighty per cent of entrepreneurs

---

[6] In this study, subcontracting is used to denote the contractual relationship between a firm (the prime) which places an order, and a firm (the subcontractor) which receives the order to produce parts, components, or repairs for the prime firm.

in the former group had an education above the secondary school vs. 70 per cent in the latter group.

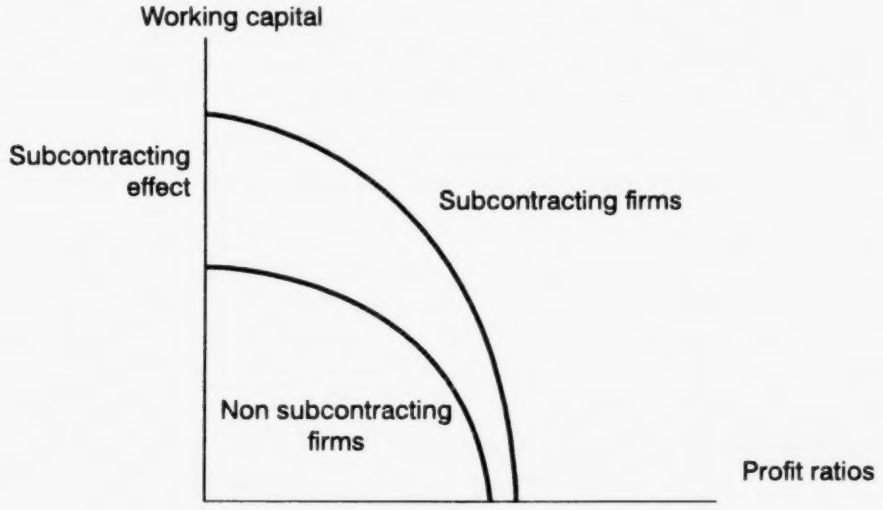
6. Subcontracting firms develop technology, while non-subcontracting firms do not.

7. Labor is better paid in subcontracting firms than in non-subcontracting firms.

8. Products are more internationally competitive in subcontracting firms than in non-subcontracting firms (49 vs. 38 per cent).

The emergence of subcontracting in Latin America can be assumed to be changing the way SMEs get involved in business. Subcontracting allows them to get into a learning process, helping small enterprises to become more competitive. Getting into subcontracting on a larger scale could help product upgrading, so firms could become more productive due to the higher value added associated with more advanced products.

Chart 1
Profit and Subcontracting



Chapter II
Financing of small enterprises in Latin America

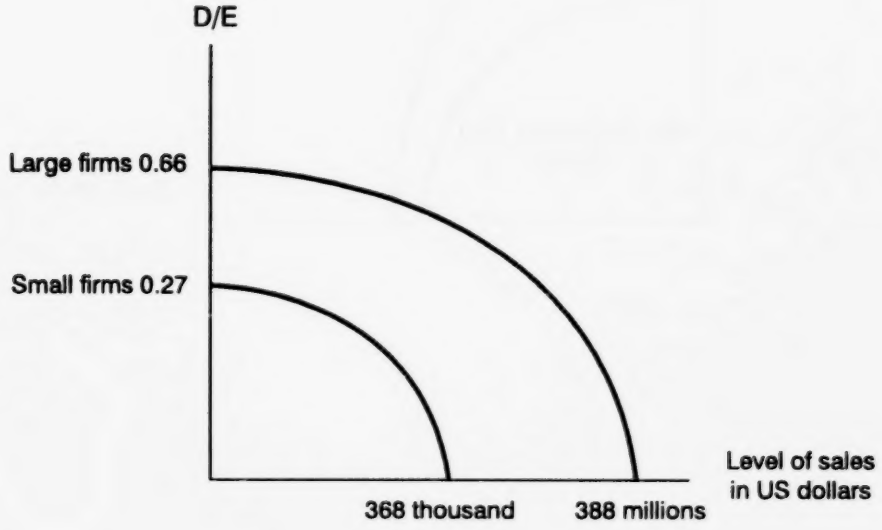
A. Capital structure puzzle

The capital structure of Latin American firms remains poorly researched, due to the fact that national accounts do not permit a detailed analysis of this issue. Thus, the analysis has to rely on specific sources, the most important being quarterly reports of registered firms in the stock market. Other sources are surveys on specific groups of firms. The main drawback of these sources of information is that they cover mainly large firms, and only occasionally medium, small or micro businesses.

The capital structure of registered stock market firms in LA shows that all firms exhibit high levels of equity, around two thirds of all financing. This sort of financial behaviour emerged during the years of high inflation that had created a paucity of long term instruments, and hence forced a reliance on equity.

Corporate financing in countries such as Mexico relies mainly on equity, the debt equity ratio (D/E) being below one in most sectors of industry. In the manufacturing sector the ratio was 0.66 in 1993, in mining it was 0.49, in construction it was 0.76 and the exception was the communications and transport sector where the ratio was 5.24.[7] The leverage level observed for large firms was very high when compared with the (D/E) ratio for small manufacturing firms. A survey of 1,035 firms (Ruiz Durán 1994), reported a ratio of around 0.27 for SMEs.

Chart 2
Debt/Equity ratios and size of firms



[7] Bolsa Mexicana de Valores Anuario Financiero 1993.

The main source of financing for SMEs comes from the entrepreneur's own resources, followed by borrowing from commercial banks, parents, relatives and friends, whereas institutional financing ranks at the bottom. The following table summarizes the funding sources of initial investment.

Table 9

Mexico - Funding for initial investment (source of funds)

	Total	Metal-working	Apparel	Plastics
Own funds				
Fixed capital	79.1	73.9	85.1	78.8
Working capital	86.8	86.1	87.8	84.9
Parents, relatives & friends				
Fixed capital	6.7	7.9	6.3	5.1
Working capital	4.5	4.5	4.9	4.2
Govt. financial institutions				
Fixed capital	2.6	3.5	2.4	1.4
Working capital	1.8	1.4	1.9	1.6
Commercial banks				
Fixed capital	7.9	10.5	4.4	8.9
Working capital	4.8	6.3	2.9	4.3
Non-bank institutions				
Fixed capital	0.8	0.7	0.0	1.5
Working capital	0.4	0.1	0.9	0.8
Others				
Fixed capital	2.9	3.5	1.9	4.2
Working capital	1.8	1.6	1.6	4.2
Total				
Fixed capital	100.0	100.0	100.0	100.0
Working capital	100.0	100.0	100.0	100.0

Source: Ruiz Durán Clemente. Economía de la pequeña Empresa, Ariel, México, 1995.

A survey of Brazilian SMEs (Kagami and Schwartz 1992) also finds that self financing was the main source of financing for SMEs; own funds represented 91.9 per cent of the initial financing and 96.6 per cent of working capital. Other sources of finance came from government financial institutions for fixed capital and from commercial banks for working capital.

In Bolivia, a study by Muller y Asociados 1991 reports that SME self-financing accounted for 64.5 per cent of initial capital, 24 per cent came from moneybrokers and 12 per cent from other sources. Lately, there has been a move by Bolivian SMEs to finance their operations from private development institutions. A survey on SME financing in Colombia (Cortes, Berry and Ishaq 1987) showed similar results. It states that "the enterprises are generally quite small at first with respect to capital, which comes mainly from their own funds (savings and severance pay) and from family loans; official credit institutions play little part in the early capitalization of SME firms".

Comparing the above surveys of SME financial statements it emerges that the debt-equity ratio is the lowest in Brazil, and highest in Mexico, which suggests that there is a positive relation between price stability and the size of the debt-equity ratio. Thus, Colombia and Mexico which have relatively stable macroeconomic environments were able to develop a credit market for firms. This has been more difficult to achieve in countries with macroeconomic instability, such as Brazil.

It seems clear that the main source of SME financing is self financing. Thus, there is a need to discuss the way cash flow mechanism interact and how small firms define their level of required indebtedness. The key parameters in the cash flow analysis are income and cost structure.

Table 10

Brazil - Funding for initial investment (source of funds)

	Total	Metal-working	Apparel	Plastics
Own funds				
Fixed capital	91.9	93.1	90.8	90.7
Working capital	96.6	97.7	94.5	97.5
Parents, relatives & friends				
Fixed capital	1.8	0.0	1.2	4.6
Working capital	0.5	0.0	1.7	0.0
Govt. financial institutions				
Fixed capital	3.5	4.5	0.0	6.4
Working capital	0.0	0.0	0.0	0.0
Commercial banks				
Fixed capital	1.9	1.1	2.5	2.9
Working capital	2.3	2.3	2.1	2.5
Non-bank institutions				
Fixed capital	0.0	0.0	0.0	0.0
Working capital	0.6	0.0	1.7	0.0
Others				
Fixed capital	0.9	1.3	0.8	0.0
Working capital	0.0	0.0	0.0	0.0
Total				
Fixed capital	100.0	100.0	100.0	100.0
Working capital	100.0	100.0	100.0	100.0

Sources: Kagami M., Schwartz Gilson, An industrial Survey on micro and small enterprises in Brazil, July 1992 Mimeo.

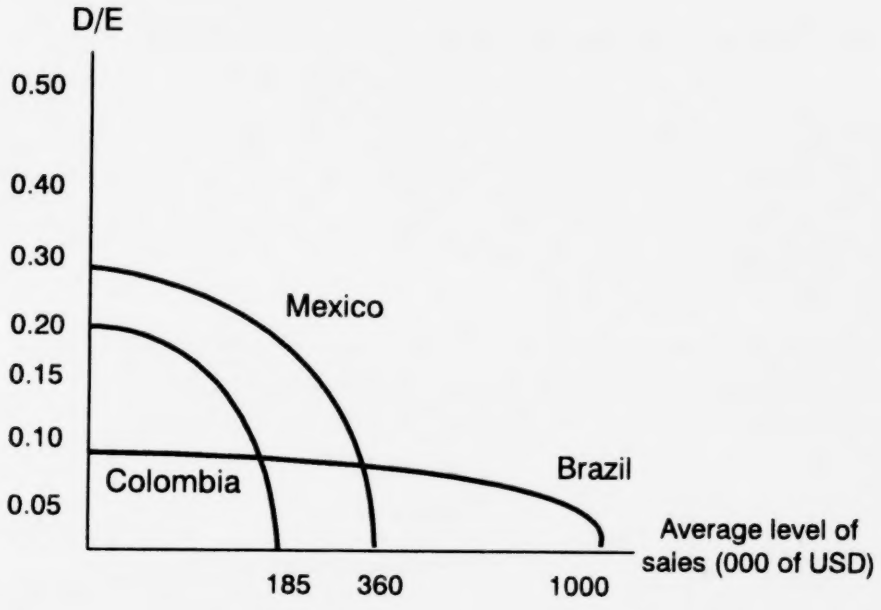
Table 11

Colombia: Main sources of initial investment for small and medium metal-working firms

Source of funds	Share (%)
Previous business:	
Sales of business	13.2
Inheritance	8.8
Savings and transfer of assets	2.9
Own resources:	
Savings and family loans	29.4
Severence and savings	29.4
Other resources and credit:	
Suppliers, savings and severence	11.8
Institutional credit, savings and severence	4.4
Total	100.0

Sources: Berry A., and Cortez M., On the Dynamism of Small and Medium Industry in Colombia: Some Possible Lessons, The Open Policy, 1990.

Chart 3
Debt equity ratios by country



The main constraint on the income of small firms in Latin American countries is their concentration in low value added activities. These activities are quite competitive, restricting price increases, and the only way to increase income is by raising volume. However, as SMEs are engaged in small scale operations they face capacity constraints which lead to stagnant sales. In these circumstances small businesses cannot raise profits by controlling costs, since they are marginal buyers of raw materials, they have to accept the price of cheap labor through minimum wage standards, and controlling costs, since they are marginal buyers of raw materials, they have to accept the price of cheap labor through minimum wage standards, and
financial and energy cost are out of their control. The best way for SMEs to increase profit margins is through a productivity strategy. The following formula summarizes the above discussion.

$$Q = S(p^{*}v) - C$$

where:
Q. profits
S. sales
p. prices
v. volume
c. cost

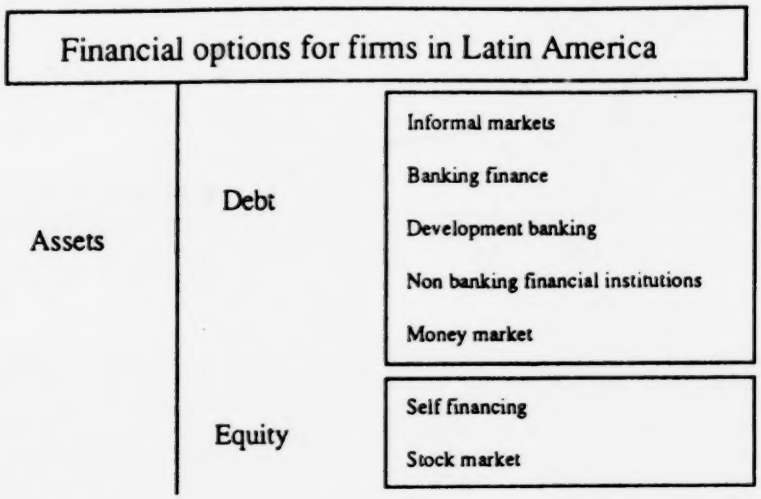
$$D/E = f(\sum_{i=1}^{n} Q)$$

Thus, stable and higher levels of profitability help to develop a larger debt-equity ratio, as entrepreneurs foresee a stable horizon to honour their future financial commitments. Although there is no large evidence to test the above hypothesis, that relation applies to the Mexican and Brazilian case, where

large debt-equity ratios are linked to a larger profit ratio (in the former debt-equity ratio is of 0.27 and the profit ratio is 19 per cent over sales, while in the latter the ratio values are 0.08 for debt-equity and 15 per cent for profit).

B. Institutional framework or the origin of credit restrictions

The existence of a low debt-equity ratio can be also explained by the institutional framework that prevails in Latin America. Financial institutions were developed in line with the idea that only large scale production, capital intensity and modern technology could get economies to move to a more integrated industrial development. Thus, financial institutions largely focused on corporate finance, rather that on a broader conception involving small businesses. Financial options for firms in Latin American countries were linked to institutional development. The balance sheet below summarizes the financial options faced by firms in the region.



B.1 Stock and money market. For small businesses the possibility to obtain financing in most financial markets remains restricted. Stock market and the money market are dominated by large corporations and only a small part of them are registered in the market. In Brazil 577 firms are registered, in Colombia 89, in Chile 263, and in México 190, and all of them could be considered giant firms. Up to date there are no mechanisms small businesses to register in the stock market to access the money market to raise finance, as is the case in some other regions of the world (e.g. Taiwan).

B.2 Banking and non banking finance. Financial deepening or the ability of a country's formal financial system to mobilize resources can be measured by the evolution of the monetary aggregates relative to GDP. Instability and hyperinflation in the region reversed financial deepening, the average relation of money and quasimoney in Latin America for the eighties and early nineties being 22 per cent of GDP. This is quite low by international standards. Chile was the only country that kept a rising ratio, reaching 39 per cent in 1992. The lowest ratio was in Bolivia in the mid-eighties due to the disintermediation caused by macroeconomic instability resulting in hyperinflation. Inflation periods also affected Argentina and Mexico. In Argentina, financial deepening was reduced through the whole period, while Mexico was able to recover from the impact of the inflation in the mid-eighties.

Colombia was the more stable experience in the region, probably explained by lower and more stable inflation and also by positive real deposit rates throughout the period. Ecuador and Peru showed a downward trend during the period due to the high inflation registered in the latter and the hyperinflation in the former, and also due to the negative real deposit rates registered in the period. During the same period in other developing regions like Asia and Europe stability and institutional diversification increased financial deepening, reaching ratios as high as 84 per cent of GDP in Portugal and 42 per cent in South Korea.

According to a World Bank report (1990) "the distress of financial markets in Latin America was reflected in a reduction in the total number of financial institutions that fell 11.7% between 1980 and 1987, but the distribution between banks and non-banking institutions was maintained, with banks comprising around one third of total financial institutions".

"During the 1980's commercial banking in Latin America suffered extensively as is documented in the chapter on banking crises. The number of commercial banks fell 9.5% in 1980-87 to a total of 560. The fall would have been greater without the assistance, intervention, or nationalization of many failing banks. Many banks remain under the temporary management of central banks, public banks or other government agencies, several years after the initial intervention and, in many cases continue to accumulate losses. In other countries, insolvent banks were promptly liquidated (Bolivia) or resold to the private sector after cleaning their loan portfolios (Chile and Mexico)".

Table 12

Financial deepening in selected countries (M1+M2/GDP)

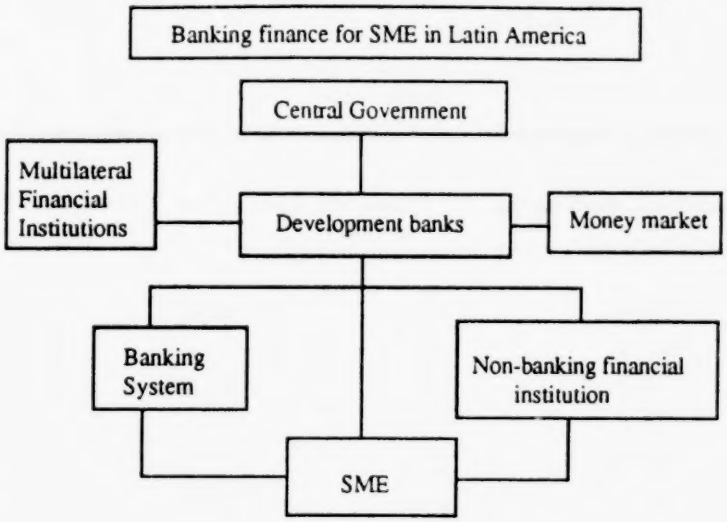
Country	**1980**	**1985**	**1990**	**1992**
Argentina	27.5	17.3	11.5	13.7
Bolivia	18.8	10.0	32.5	n.a.
Chile	25.9	40.0	40.2	39.0
Colombia	20.3	19.8	19.3	20.6
Ecuador	22.6	19.5	16.5	16.6
Mexico	29.0	25.2	24.0	30.9
Peru	21.2	23.3	21.0	14.5
Latin America	23.6	22.2	23.6	22.6
Korea	32.9	34.8	38.3	42.3
Turkey	21.8	31.2	33.1	n.a.
Portugal	89.6	87.5	73.5	84.1

n.a.: not available
Source: IMF, International Financial Statistics. Annual Report 1994

Financial distress has been larger for small businesses. The formal financial system has focused on large business, whereas lending to SMEs was marginal and costly, both for the banks and for the customers. Government response to restrictions of the banking system to lend to SMEs has been to develop a new linkage between the commercial banking system and Development Banks through

refinancing, moving away from direct credits that were the main way to finance SMEs by development banks. The model can be summarized as follows: Banking system is focus on corporate finance, lending marginally to SME, central government through development banking institutions has established a system of refinancing, designed to promote bank lending to SME. The operation funding is through the budget, contracting new debt with multilateral institutions (i.e. World Bank and Interamerican Development Bank) and in some cases issuing paper in the money market. The interest rate charged to small businesses is directly related to the sources of funds, but in all cases the cost of money is below the market rate. The basic idea is that this mechanism allows SMEs to access the banking system at a lower interest rate. Refinancing has incorporated today also non-banking financial institutions, in order to facilitate the access of SME to financing.

Refinancing has not substituted direct lending in all cases. Some development banks in the region have maintained direct lending, to avoid the intermediation of banks that still avoid to lend to SMEs due to the fact that the margins are lower than on corporate lending. Despite bank resistance to extend lending to SMEs, the mechanism has allowed the financing of a larger number of firms, through what has been called in some Latin American countries "policy of credit massification".



Bolivia. Hyperinflation and instability have hindered the evolution of the financial system in Bolivia. Currently, there are 15 private domestic banks, 4 foreign banks, 13 mutual savings for housing credits and a group of private financial non banking institutions. Private banks are by far the largest formal sector institution with 82 per cent of total assets, and their lending is mainly for large firms. As pointed out by Laserna (1993) "in Bolivia the financial system has an oligopolic system that discriminates against SMEs through higher interest rates and shorter term credits. The Data bank of the industrial sector shows that the cost charged to SME is 24 per cent higher than to larger enterprises. This sort of discrimination is born partially in the risk and cost of extending credit to SMEs, but is also influenced in personal relations and politics. Deposits come mainly from a small group (81.5 per cent of total deposits comes from 6.3 per cent of the clients), and as a consequence credits are also allocated to a small group of clients (7.1 per cent of the clients got 73.2 per cent of the banking system portfolio). This means that large business gets the largest share of credits at the lowest interest rate". The Central Bank has tried to face the lack of credit in certain sectors with some specific lines of credit (mining, industry, agriculture, etc.) through the banking system, but without any specification regarding size, so they could be accessible to any firm.

In fact, these credits are also used by large firms, due to the fact that banks are usually not interested in credits below US$5 million dollars (Mac Lean 1993). Lately bank regulations were relaxed to allow the creation of Regional Banks that can get into operation with an initial capital of US$500,000 which is around one fifth of the required capital for traditional banks. These new institutions are expected to help develop better ties between the banking system and SMEs.

In the formal financial sector SMEs can get funds through the private financial non-banking institutions that get funds from multilateral financial institutions, or from special funds (for e.g. Small Projects from IDB). The table below, lists non-banking institutions which lend to microenteprises and their funding.

Table 13

PRIVATE INSTITUTIONS FOR SOCIAL DEVELOPMENT		
Name of the institution	**Technical support**	**Source of funds**
PRODEM	AITEC	US-AID, IDB, United Nations Fund for Capitalization, PL480. DIFAD, and from the disappeared Social Emergency Fund
FIE	IDB	IDB, DIAKONIA, ICCO, CRS, SAT y COTESU
IDEPRO	ILO/PRELAC	Netherlands government, CRS, UNDP, SAT
CIDRE	IDB	IDB
PROCREDITO	GTZ	GTZ, COTESU, IDB
PRISMA	MEDA	CRS, LWR, ANED and MEDA
PROA	US-AID	US-AID, Banco Nacional de Bolivia

Source: Mezzera Jaime, Crédito Informal: Acceso al Sistema Financiero, PREALC, OIT, 1993

These institutions finance SMEs at lower interest rates and on better terms in order to ease the supply of fixed or working capital, as explained in the table below.

Table 14

PRIVATE INSTITUTIONS FOR SOCIAL DEVELOPMENT (credit conditions)			
Programmes	Average amount of credit	Term period	Purpose of the credit
Small credit Programme	180-270 dollars	2.5 and 5 months	Working capital
Intermediate programme	350-900 dollars	3 and 14 months	Working capital and small investments
Median programme	1200-3300 dollars	12-24 months	Working and investment capital
Associations credit programme	480 thousand dollars		Associations in the manufacturing and services

Source: Mezzera Jaime, Crédito Informal: Acceso al Sistema Financiero, PREALC, OIT, 1993

Colombia. The Colombian financial system is characterized by specialized financial institutions rather than by universal banks. Banks finance short term lending, Corporaciones Financieras resembles investment banking; Compañías de Financiamiento Comercial finances consumption; Corporaciones de Ahorro y Vivienda lend for housing; Financial cooperatives are short term lenders; Sociedades de Capitalización, Fondos de Inversiæon, Fondos Mutuos, Fondos de Empleados and Sociedades Administradoras de fondos de Cesantæia y pensiones y las compañías de seguro, resembles also investment banking; Sociedades Fiduciarias, sociedades de leasing and factoring, are refinancing institutions. Most financial assets are concentrated on banks (61%) followed by housing finance institutions (22%) and in the third place are located investment banks (11%). All these financial institutions have restrictions for lending to SMEs:

1. Most banks do not allow credits below US$1,700.00
2. Spreads are on average 13 points of the reference rate
3. Collateral is required in all cases
4. Clients must have an account before they can apply for a loan.

The financing of SMEs has been encouraged through refinancing policies; the government has set up some credit lines to encourage lending, as shown in the table below.

Institutional financing of SMEs is governed by the National Development Plan (1991-1994) and is executed through 45 Foundations, 6 financial intermediaries, 51 Chambers of Commerce and the Colombian National Confederation for Microenterprises (CONAMIC).

The National Planning Department is in charge of putting into effect the NDP and is supported by the Consejo Nacional de la Microempresa and the Evaluation Council. The former is in charge of programming and bringing together all political forces to accomplish the goals of the programme, while the latter evaluates how the Interamerican Development Bank funds are channelled. As in most Latin American countries, the Colombian financial system operates as a refinancing system. It is derived from "Programa Global de Crédito para la Microempresa" credit line of the Interamerican Development Bank (loan program-848), which is managed by the Central Bank and is used for refinancing private financial institutions that are involved in the program.

Ecuador. As in other Latin American countries, macroeconomic instability affected the development of the financial system. The formal financial system is built around banks, private financial companies, other financial intermediaries and savings and loans associations for housing. Credit to the private sector as a percentage of GDP was only 15 per cent in 1992, which is quite low by international standards. Although the financial system is supposed to support firms irrespective of size, private bank lending to SMEs is restricted to the refinancing they get from development banks.

In addition to the refinancing system, some private banks, for e.g. Banco del Pacifico have developed programs focused on SMEs. It finances microenterpreneurs with the idea of helping them to grow and get them into the Small business program that they have also developed. Credit size by individual firm ranges from 200 to 360 thousand dollars, and the interest rate charged on new credits is around 23.25 per cent, which is below the market rate; collateral is easy to get and could be another producer.

Beside banks, some cooperatives became involved in financing SMEs. Cooperativa de San Francisco de Asis is a cooperative that has grown substantially. It has a program of small credits, financing housing, purchases of machinery and equipment and personal use. The collateral for small credits are deposits, and a portion of them is sterilized during the credit period. The sterilization percentage varies from 10 to 30 per cent, in accordance with the proportion of money used for personal expenditure.

Development banking has been a key for channelling financial resources to SMEs.

Table 15

Credit lines for SME in Colombia		
Linea Quinta for SME	Credindustria	Credicomercio
Rediscount operations through banks and financial corporations.	Rediscount through Corporación Financiera de Desarrollo and private corporations.	Rediscount operations through Corporación Financiera de Desarrollo, and banks with differences.
Source of funding: World Bank.	Source: Own funds.	Source: Own funds.
Available for SME in manufacturing, agro-business, mining and related service.	Available for SME with assets not above: 814 Colombian millions and most represent not more than 70 per cent of total debt.	Available for SME on services and commerce.
Requirements: Assets must be below 614 Colombian millions and SME must provide at least 30 to 20 per cent of the project financing.	Must be used for working capital and fixed assets.	Must be used for capital goods.
Must be used in working capital or fixed assets.	Term: Working capital, plus liabilities substitution - up to 3 years. Fixed assets - up to 5 years. Principal payments must be done quarterly.	Term: up to 5 years. Repayment of principal as agreed.
Term: Working capital - up to 5 years. Fixed assets - up to 10 years. Amortization: by semester.	Grace period: Working capital and liabilities restructuring - up to 6 months. Fixed assets - up to 12 months.	Grace period: up to 12 months.
Grace period: Working capital - up to one 1 year. Fixed assets - up to 3 years.	Interests: Working capital and liabilities restructuring - Reference rate + 7.5% quarter on advance.	Interests: Not below reference rate + 7.5 per cent of quarter on advance, equivalent to quarter on arrears.
Interests: Reference rate + 6% + arrears capitalization of 0.25% + quarter on advance.	Amount of the credit: up to 60 per cent of established firms and up to 70 per cent of new projects.	Amount of the credit: Minimum up to 3.8 Colombian millions. Maximum up to 70 per cent of total required resources, with the restriction that future indebtedness must not be above 75 per cent.
Amount of the credit: up to US$500 thousand and it must not go beyond 70 to 80 per cent of the project value.	Collateral: mortgage, assets.	Collateral: mortgage, assets.
Collateral: Fixed assets or mortgage.		

Source: PREALC, El Crédito Informal en Bogota, Cali y Medellin, OIT, 1990. PREALC, Lecciones Sobre Crédito al Sector Informal, OIT, 1990. Mezzera Jaime, Crédito Informal: Acceso al Sistema Financiero, PREALC, OIT, 1993.

In 1980, Corporación Financiera Nacional, the country's largest government owned development finance institution, established a fund - Fondo de Fomento para la Pequeña Industria y la Artesanía (FOPINAR) - to refinance loans from local financial institutions to small enterprises. The fund is autonomous and operates from a head office in Quito, and from regional branches. Its financing has come principally from multilateral institutions via the government, where the latter bears the foreign exchange risk.

There are now some forty participating financial intermediaries. The government owned Banco de Fomento Nacional (BFN) primarily an agricultural bank, accounts for 45 per cent of all loans and caters to about 75 per cent of all borrowers. Private development finance institutions and commercial banks account for the rest. To participate in the program, the institutions must meet criteria regarding the quality of their FOPINAR portfolio, their overall debt-equity ratio, and their standing with the central bank and the superintendency of banks. In order to encourage the participating institutions to become more independent, the program requires them to provide 10 per cent of project costs from their own resources.

So far, loan collections have been quite good. Arrears on the FOPINAR part of the discounted loans to private development finance institutions and commercial banks have averaged less than 3 per cent.

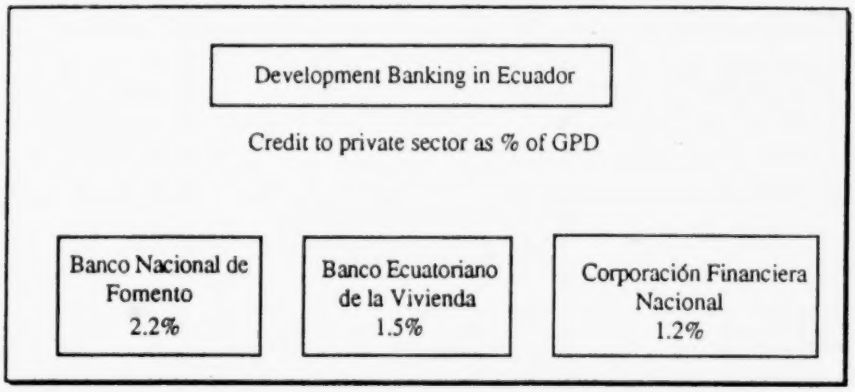

Development Banking in Ecuador
Credit to private sector as % of GPD
Banco Nacional de Fomento 2.2%
Banco Ecuatoriano de la Vivienda 1.5%
Corporación Financiera Nacional 1.2%

Table 16

COLOMBIA: FINANCIAL PROGRAMS FOR SME

Financial programs for SME derived from National Development Plan

	Amount in millions of US Dollars	%
Loans from Interamerican Development Bank		
- IDB-800	4,5	13,8
- IDB-848	14,0	43,1
Local resources linked to IDB loans	6,0	18,5
Revenues from loan 848 IDB	4,0	12,3
World Bank	3,0	9,2
IDB loan to Solidarity Groups	1,0	3,1
TOTAL	32,5	100,0

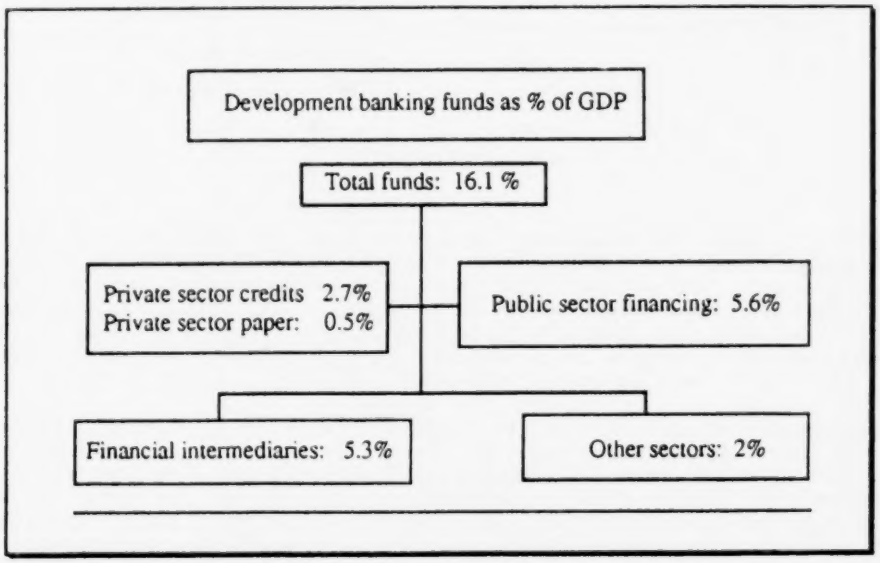
Financial Programs for SME outside National Development

President program for SME	1,0	28,6
International cooperation programs	2,0	57,1
Foundations or non-governmental agencies	0,5	14,3
TOTAL	3,5	100,0

Source: Mezzera Jaime, Crédito Informal: Acceso al Sistema Financiero, PREALC, OIT, 1993.

FOPINAR's independence has allowed it to respond flexibly to changing conditions. FOPINAR actively promoted the program and the terms that were sufficiently generous to attract the financial institutions. It has helped to train the institutions' staff, and they and FOPINAR have attached a high priority to supervising the loans. Automatic debiting of the institutions for amounts due to FOPINAR gives them an incentive to judge their lending carefully.

Mexico. One of the main goals of the government in Mexico has been to develop a sophisticated financial system that could compete with world financial institutions. Today, the financial system is very large by Latin American standards. At the beginning of 1995, there were more than 60 commercial banks, 322 credit unions, leasing companies, factoring companies, insurance companies, and investment companies. All of them are mainly focused on corporate finance. To induce financing of SMEs by these institutions a refinancing system through development banks has been developed. Development banking in Mexico has been twofold: first, it acted as a large provider of resources to the public sector, and second it provided financial support to the business sector. Development banks were created in the 1940s, and their operations in support of the business sector up to the late eighties was through direct lending. This support was delivered mainly to large private and public enterprises. In the late eighties, a reform introduced a new credit system, moving away from direct lending toward a system of financial intermediaries refinancing. The goal was to reach a larger proportion of firms, mainly SMEs, through a program of credit massification. The diagram below shows the size of development banks' resources and how they were distributed in 1993.


Development banking funds as % of GDP
Total funds: 16.1 %
Private sector credits 2.7%
Private sector paper: 0.5%
Public sector financing: 5.6%
Financial intermediaries: 5.3%
Other sectors: 2%

Source: PREALC, Lecciones Sobre Crédito al Sector Informal, OIT, 1990

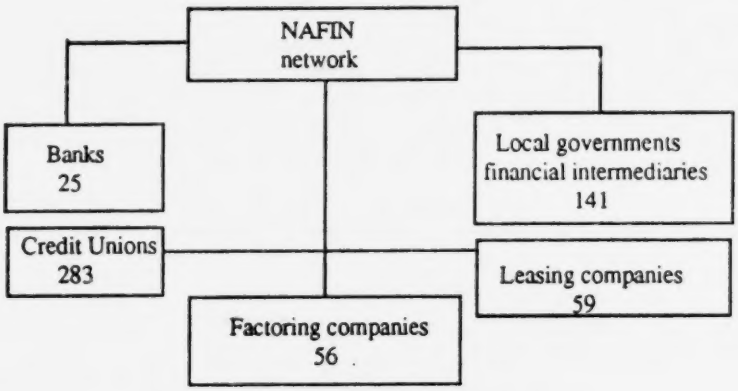
The institution that has been particularly active in supporting SMEs among development banks is Nacional Financiera (Nafin). Among the programs that are specifically designed for this purpose are: financial program for SMEs (Promyp), modernization program, ecology program for SMEs, program to support technological development, program to support consultants development, program for physical infrastructure and regional development. The table below presents general lending refinancing conditions as prevailing in 1994.

The Nafin financial network for refinancing has increased the number of SME benefiting from its credit programs from 6.5 thousand firms in 1988 to 127,225 thousand firms in 1993. Nafin credits to SMEs reached 1.6 per cent of GDP. The following diagram shows the Nafin network that has been developed for refinancing.

Table 17

Lending conditions of Nafin			
	Size definition by sales levels in USD	**Interest Rate in domestic currency***	**Maximum amount of Promyp credit**
Micro	286 thousand	CPP + 6	225 thousand USD
Small	2.9 million	CPP + 6	2.2 million USD
Large	6.4 million	CPP + 6	

Source: Lopez Espinosa Mario El financiamiento de la pequeña empresa. PNUD 1994
*CPP is the treasury certificates of Mexican Government that is taken as the reference rate.



The second largest development bank involved in SME support is Banco Nacional de Comercio Exterior (Bancomext) that finances export firms and their suppliers. In this case SME enterprises can get direct credits from the Bank or indirectly through large corporations that export; the financial program to support SMEs in 1993 was of almost 7 million dollars, which was used to finance 13 thousand enterprises, with a loan average of 494 dollars for each firm. The main programs of support are given in the table below.

C. Informal finance: Formal financial arrangements are often not well suited to the needs of the non-corporate sector. The sums involved can be too small for a formal institution because many of the costs of advancing a loan or accepting a deposit are independent of the size of the transaction. Often the cost to formal institutions of opening branches in villages and small towns is not justified by the business that can be generated. Non-corporate borrowers rarely have collateral acceptable to banks. Their creditworthiness resides in their human capital, which is difficult for formal intermediaries to gauge. The interest rates that banks are allowed to pay for deposits or to charge on loans often fail to reflect these factors. All this makes supplying financial services to the informal sector unprofitable for formal institutions. As a result, a large informal finance market has emerged in developing countries.

The informal sector accounts for most of the financial services provided to the non-corporate sector. In addition to family and friends, who provide a large percentage of the loans, informal finance consists of professional moneylenders, pawnbrokers, tradespeople, and associations of acquaintances.

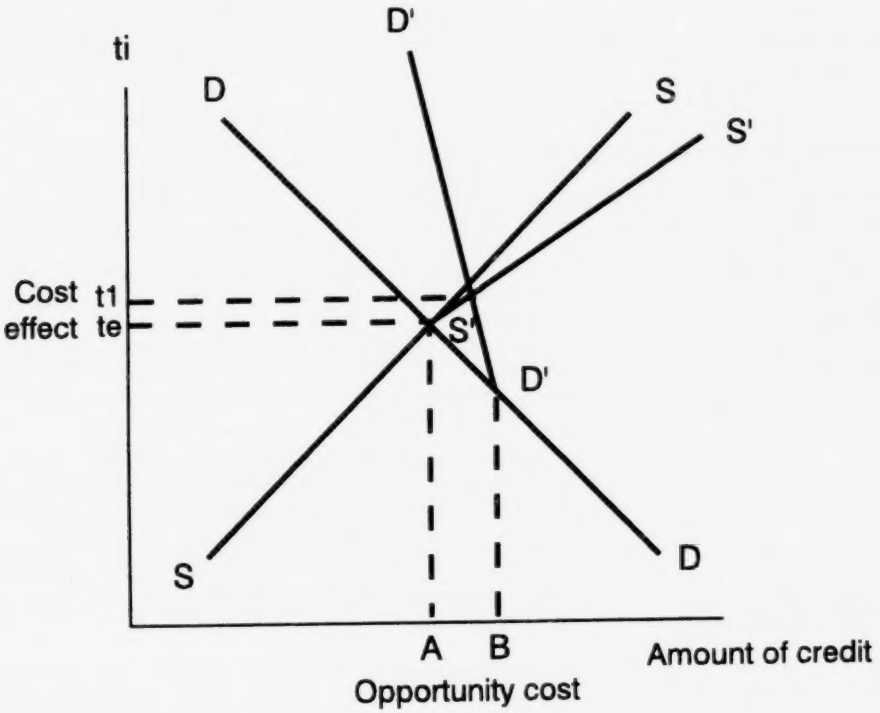
Informal financial arrangements reduce transaction costs and risk in ways denied to formal institutions. Money lenders, for example, can operate out of their own homes or on the street, maintain only the simple accounts, and mix

finance with other business. The services they provide are outside the review and control of the monetary authorities. The remaining costs can be fully reflected in implicit or explicit interest rates.

Freedom from regulation allows informal agents greater flexibility. But it also denies them many of the legal sanctions available to formal intermediaries. In place of formal mechanisms, informal agents rely on their knowledge of one another and on local sanctions to reduce the risk of lending. Social standing and the ability to obtain future financial services are often at stake in the market for informal financial services. These sanctions are effective which is why informal financial arrangements are so widespread.

For SMEs, informal finance is the option to get the money on time to finance day to day operations. Although it might be more costly, the higher interest rate t_i is compensated with what can be called the opportunity effect (AB), which is the additional credit that SMEs can get over the available resources in the formal market. This is shown in the following diagram.

Chart 4
Effects of informal markets over loanable funds



Informal finance has evolved over time and a sophisticated lending structure now exists in a number of Latin American countries. Low income groups saving traditions have been left out of economic analysis, assuming there are negligible and have no effect over long term accumulation. Statistics on this type of informal finance are not available, so it has been easier to eliminate it from the analysis. The only country that has credible statistics on informal finance is Taiwan, where it accounts for one fifth of the financial market. Latin America's informal sector might be very big, but governments have not tried to get an estimate of its size. The following section describes different informal markets where SMEs can obtain short term financing.

Table 18

Bancomext programs for SME					
	For whom?	Purpose	How much?	Term	Interest rate
Working capital	Export firms, direct of indirect	Productive cycle	Up to 100% of sales, no more than US$5 million	90 days or 360 days	LIBOR + 2.5 CPP + 3
Capital goods	SME firms	Capital goods	Up to 80% of value	Up to 5 years	LIBOR + 5 CPP + 3
Inputs imports	Export firms	Raw materials & parts	Up to 100% of sales, no more than US$10,000	Up to 90 days	LIBOR + 3 CPP + 3
Indirect exports	Suppliers		Up to 80% and no more than US$5 million	Up to 180 days	LIBOR + 2.5 CPP + 3

*For loans on dollars Bancomext charges LIBOR rate plus an additional rate, in pesos a reference rate CPP plus the intermediation cost.

Source: BANCOMEXT, Annual Report 1994.

C.1. Rotating savings and credit associations. Rotating savings and credit associations (ROSCAs) are a popular form of informal finance. They have various aliases: tanda in Mexico, pasanaku in Bolivia, san in the Dominican Republic and syndicate in Belize.

Roscas intermediate in the most basic way. A small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The money collected (the fund) is then given in rotation to each member of the group. In Latin America the Roscas system is mainly used by the group itself or by merchants to finance the purchase of consumer durables. Loans are interest free in most Roscas; the amount received is equal to the total paid in by the members.

Recent research in Bolivia (Adams and Canavesi 1989) showed that one-third to one half of all adults living in urban areas often participated in Roscas and that their payments amounted, on average, to about one-sixth of their salaries. These associations were even found among employees of formal financial intermediaries. Despite hyperinflation and poor loan recovery by formal lenders, Bolivians reported few problems in their Roscas. More than 90 per cent of the people interviewed joined Roscas primarily because they wanted to save more, and felt that membership forced them to do so.

SMEs could get into the ROSCAs system to finance purchases of their goods, but they do not use this sort of financing to accumulate, as opposed to Korea (kye) where they use them for the purchase of capital goods.

C.2. Informal savings banks, moneylenders and the short term credit paradigm

SMEs commonly require small amounts of short term funds to cover immediate expenditures, such as a business opportunity, a social obligation, r an emergency. If they are associated with the formal sector they could use their credit line, but often they are not linked with banks, so funding comes from informal savings banks (similar to the savings and loans associations of US), moneylenders or pawnbrokers, but is more likely to be borrowed from relatives or friends. The choice of arrangement will depend on cost and convenience. Colombia and Mexico have conducted research on the subject and there is information on costs and terms of the credits. In Mexico, Perez Gea (1993) analyzed the Survey on Semiurban and

Rural Financing realized by Secretaría de Hacienda y Crédito Público (1993) and found that in this region formal credit accounts for only 16 per cent of total credit, half of it coming from the Rural Development Bank (Banrural) and the other half from commercial banks. Sixty seven per cent of credits have been used to finance crops and small businesses. Informal savings banks and credit unions have contributed only 2 per cent of the financing in this area, so the main source of financing have been moneylenders and the pawnshops. The amount of credit was rather small, between US$30 and US$3,000, with an average monthly cost of around 20 per cent. Thirty five per cent of credits were given for a one month period, and 26 per cent for a period of 2 to 6 months.

In Colombia, Parra (1993) outlines the conditions that small businesses have to face when they get money from the moneylenders; Castro (1993) describes a similar scheme for Peru, and although no analysis exists for other countries, it could be argued that the same pattern prevails in most Latin American countries.

C.3. Non-governmental organizations and the finance of SME

One of the ways to finance SMEs has been through non-governmental organizations (NGO) that usually work with communities or with micro enterprises; although all Latin American countries have some sort of financing through NGOs, the largest operations can be found in Chile and Peru. In Chile they were multiplied during the dictatorship period, as a way to help resistance and new forms of organization for the communities. NGOs had never defined themselves as financial intermediaries. One of the most successful NGOs has been Accion Internacional, which funds many SMEs in the region.

Table 19

Percentage of Employees Participating in intraoffice ROSCAs (pasanakus) in selected organizations in Bolivia 1987

Financial Institutions	16
Central markets	22
Sales	8
Business offices	15
Government offices	17
Private businesses	10
Labor groups	10
Hotels	10
Laboratories	22
Public administration	10
Private clubs	10
Industrial plants	24
Transportation	16
University	10
Communication businesses	9
Miscellaneous	10

Sources: Adams D. and Delbert F., Informal Finance in Low-income Countries, Westview Press, 1992

D. Problems of access by SMEs to formal sector finance

In almost all Latin American countries, SMEs face obstacles in obtaining formal sector credit. Surveys in different countries support the idea that banks charge larger interest rates to SMEs, collateral is too high, and procedures to get the credit are complicated. Ecuador survey by Samaniego and Maiguashca (1989) points out that the largest difficulty in getting formal sector credit was the procedures to get the credit, followed by the high interest rate charged on loans. In Mexico, a survey by Ruiz (1995) points to similar problems, but ranked in different order: high interest rates and procedures getting the largest weight in the answers of the entrepreneurs. For Brazil, a survey by Kagami and Schwartz

(1992) specifies that "only 13.1 per cent declared to be unaware of government credit programs, high interest rates being the main reason for not applying. Lack of mortgage was identified as a problem by 32.2 per cent of the sample. Most of the firms (87.8 per cent) get no government support".

The often expressed request by SMEs for lower interest rates is quite reasonable, since the formal sector charges high spreads to the credits that are not homogenously distributed. High spreads are partly explained by the inefficiency of financial intermediaries, which also explains why commercial banks cannot get into small cities or rural areas.

The lack of collateral and complicated procedures are the main obstacles for SME access to the formal financial system. Procedures are designed in the banking system to fulfil the needs of corporate clients, rather than small firms; large firms can obtain working capital very rapidly due to their credit lines already available in the bank. For a small firm in Latin America, the procedures linked to getting a loan could take a long time. Banks usually do not use project evaluation as collateral. Instead, they request that firms have assets larger than the amount of the loan. In Mexico the ratio of assets given as collateral to the amount of the loan is 2 - 2.5.

Table 20

Terms of informal credit
Share (percentage)

	One day	One week	One month	2-6 months	One year	Other	Total
Relatives	1.03	18.93	37.18	19.45	3.79	19.62	100.00
Friend	0.65	20.78	31.49	32.14	1.62	13.32	100.00
Tradespeople	3.45	22.99	28.74	28.74	2.30	13.78	100.00
Moneylender	0.00	9.26	40.74	29.63	5.56	14.81	100.00

Number of payments in which credit is completely payed
Share (percentage)

	One	Several	Other	Total
Relatives	64.48	32.93	2.59	100.00
Friend	65.70	31.39	2.91	100.00
Tradespeople	57.47	36.78	5.75	100.00
Moneylender	27.78	64.81	7.41	100.00

How credits are payed
Share (percentage)

	Cash	In-kind	Assets	Work	Other	Total
Relatives	92.93	3.45	0.33	2.47	0.82	100.00
Friend	88.11	5.79	0.00	4.88	1.22	100.00
Tradespeople	87.64	5.62	1.12	5.62	0.00	100.00
Moneylender	74.07	1.85	0.00	18.52	5.56	100.00

Sources: Secretaria de Hacienda y Crédito Público, Ahorro y Crédito en Poblaciones Semi Urbanas y Rurales, México 1993. Secretaria de Hacineda y Crédito Público, Encuesta Sobre Sistemas Financieros en Poblaciones Semi-Urbanas y Rurals, México 1994.

Table 21-1

Colombia **Informal credit for low income groups**
A. In kind loans for commerce. Wholesale traders (Plante) finances a one day operation to small traders. Amount: no more than 50 USD Interest: 10 percent daily Collateral: personal trust Procedures to get the credit: verbal, and signing a receipt.
B. Cash loans Moneylenders finances a one day trading operation of micro entrepreneurs Amount: no more than 50 USD Term: one day Interest: 10 percent daily Collateral: personal trust Procedures to get the credit: verbal, and signing a receipt.
C. Rotating credit. Moneylenders finances one day trading operation, that could be refinanced Amount: variable but no more than 100 USD Term: Initially one week, but it could be refinanced Interest: 10 percent daily Payment form: interests are paid daily and principal at the end of the period Collateral: personal trust Procedures to get the credit: verbal, and signing a receipt.

Table 21-2

Colombia **Informal loans for middle income group, that covers typical microenterprises in the manufacturing and service sectors (electrical and auto industry). At least four different types of financial arrangements could be described**
A. In kind loan for weeks (matipongo: you pay a debt and you get a new one) Amount: variable, but no more than 100 USD Term: 7 days Interests: between 5-7 per cent daily Payment form: interest are payed daily and principal at the end of the period Collateral: personal trust Procedures: Verbal, and signature of a receipt
B. Cash loans for months Amount: variable, up to 200 USD Term: 30 days Interests: between 10-20 per cent monthly Payment form: interest and principal at the end of the period Collateral: personal trust Procedures: Verbal, and signature of a receipt
C. Loan for 30 to 60 days, daily payment Amount: variable, up to 200 USD Term: 30-60 days Interests: around 20 per cent Payment form: daily quotas that includes interest and principal Collateral: personal trust Procedures: Verbal, and signature of a receipt
D. Discounting checks. Moneylenders accept to cash checks with 10 per cent discount, up to 300 USD

Table 21-3

Colombia **Informal Credit for SME manufacturing enterprises with fixed assets larger than $5,000USD and more than 5 employees. The operations available for financing are discount operations, factoring and cash credits**
A. Discounting checks. Moneylenders accept to cash checks with 10 per cent discount, up to 300 USD
B. Factoring operations. Amount: Up to 300 USD Term: variable and related to invoice period Interests: 5-10 per cent month Payment form: one payment when invoice is due Collateral: invoice Procedures: Verbal, and signature of a receipt
C. Mutual or personal loans Amount: Variable Term: variable, but no more than 180 days Interests: 5 per cent month Payment form: interest monthly payments and principal in one final payment Collateral: mortgage Procedures: Verbal, and signature of a receipt

Sources: PREALC, El Crédito Informal en Bogota, Cali Medellin, OIT, 1990. PREALC, Lecciones Sobre Crédito al Sector Informal, OIT, 1990. Mezzera Jaime, Crédito Informal: Acceso al Sistema Financiero, PREALC, OIT, 1993.

Table 22

Ecuador: survey on SME
Problems that SME faces to get credit (percentage)

Problem/city	Quevedo	Sto. Domingo	Manta	Esmeralda	Portoviejo
Procedures	45.3	31.7	38.3	32.7	32.2
High interest rates	34.3	20.4	5.8	38.0	10.4
None	11.0	8.5	37.3	13.0	41.7
Collateral	8.4	15.8	4.9	8.7	4.2
Others	1.0	6.1	7.9	2.9	3.1
Lack of knowledge	0.0	14.1	3.0	4.7	2.1
No Answer	0.0	2.4	2.8	0.0	6.3

Source: Survey and processed by INSOTEC

Table 23

Mexico: survey on SME
Problems that SME faces to get credit **(percentage)**

	Total
High interest rates	32.0
Procedures	29.0
Collateral	21.0
Amount requested too low	5.0
Others	13.0
Total	100.0

Source: Ruiz Durán C. Economia de la pequeña Empresa

Banks also request that assets given as collateral must be fairly liquid so that they can be easily sold if the loan is not repaid. Another problem faced by SMEs is the size of the credit requested. The amount of credit in the informal sector begins at around US$100 dollars, but that is too small for formal financial institutions. Banks do not even consider an application for such small amounts.

This problem is linked to the basic problem of the Latin America financial system which is the lack of a broad institutional framework to attend to different levels of income.

From the above discussion the following conclusions on the main obstacles to SME finance in Latin America emerge:

1. Lack of financial options. Institutional development is weak and concentrated in corporate finance, while financial intermediaries are inefficient and cannot cope with SME financing.

2. Lack of collateral. Schemes to measure risks had been developed for corporate lending, but there is no design for small projects, giving rise to very high collateral requirements. Moreover, banks often do not accept certain types of collateral.

3. High cost of money. Financial institutions have a high cost of handling small loans.

4. Lack of a structure to finance long term growth. Long term credit is difficult to obtain in Latin America due to macroeconomic instability, hyperinflation and also the lack of institutional investors.

5. Lack of financial tools to promote exports and technology. Firms find it difficult to finance exports and technology, due to the fact that commercial and development banks have not been able to design specific projects to finance this type of SME activities.

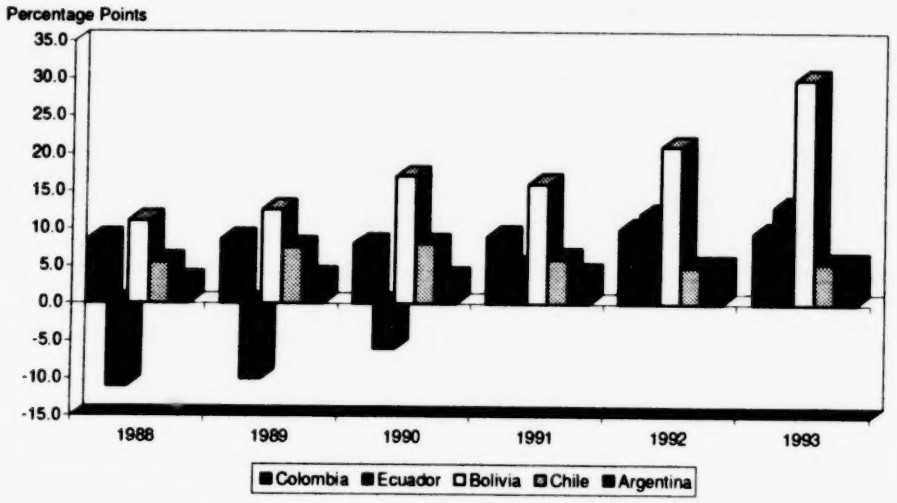
6. Banks do not like SMEs. Banks are corporate oriented to avoid risk.

7. Government programs are tiny compared with the number of SMEs. As shown in the above description, credit given by developing banks to SMEs is quite small as a percentage of GDP.

8. Government regulation of the traditional financial system has not been able to avoid failures of domestic institutions, affecting confidence in the financial system in some countries during the eighties: Argentina, Chile, Uruguay, Colombia, El Salvador, Dominican Republic, Costa Rica, Bolivia and Peru.

Chart 5

Financial spreads in selected countries

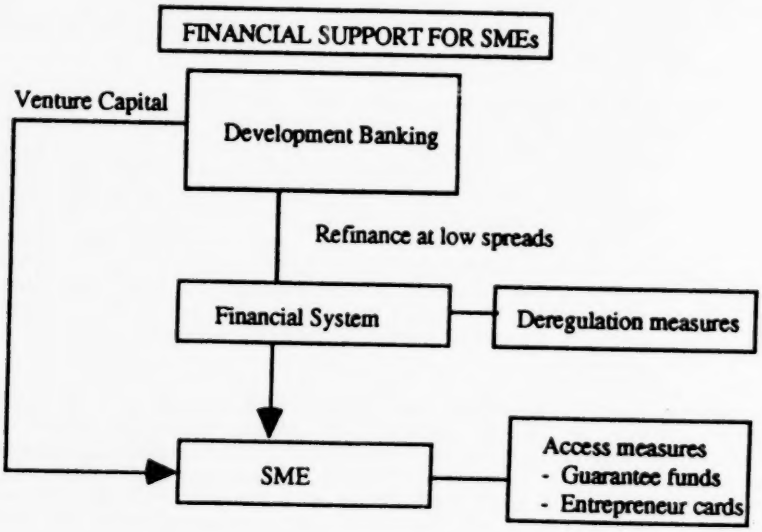


Chapter III
Measures to improve SME's access to financing

A. Government measures to support SME's financing

Latin American promotion programs for SMEs have focused on the area of financing in isolation from other measures, thus reducing the effectiveness of these policies. Other regions have linked credit programs to industrial policy, thus improving the performance of these programs in terms of employment creation, export performance, import substitution, entrepreneurial development, poverty alleviation, and regional development. The allocation of credit in Latin America has been governed by a firms' size, rather than on the basis of an industrial strategy that could reorganize the whole economy into an integrated structure.

The basic policy in Latin America has been to cope with the problem of small firms through development banking, approaching it through refinancing operations of the formal financial system and creating a series of supportive measures to encourage the traditional system to increase lending.



1. Credit guarantee schemes have become a natural component of the Latin American financial system to improve the capacity to reach small firms which usually lack collateral. There are different modalities across Latin America, one of the most successful being the Ecuador Reciprocal Collateral National System. It was established in 1980, as a program that integrates SMEs with industrial chambers, professional associations and loan & savings cooperatives to develop a system of certification that could be used as collateral. These institutions constitute credit guarantee corporations which issue certificates that allow small entrepreneurs to access the banking system. SMEs which are associated to this

corporation contribute to its capitalization, and the capital becomes the guarantee fund. The Commission for the issuance of the certificate is around 4 percent, and the income received is used to increase the guarantee fund.

In addition, corporations are linked to a fund called "Corporación de Retrogarantía" which gets its funds from the Central Bank, Banco de Fomento, from corporations and from its institutions willing to provide additional resources. The loan risk is shared in the following proportions: 60-65 percent by Corporación de Retrogarantía, 20-25 percent by corporations and 10-20 percent by other financial institutions.

In Mexico, there is a relatively new program issuing collateral, which operates through Nacional Financiera, but is independent of associations or for any other source. Action of the program is relatively small and difficult to obtain.

2. Entrepreneurs' cards. These cards have been issued in different Latin American countries as a way to allow a better access to loans for working capital; it provides another way to certify the collateral for rotating credits; cards are issued by the financial system in association with development banking.

3. Venture capital. Some countries in the region have engaged in creating funds to provide venture capital to SMEs with funds from international institutions. These funds are relatively small and are oriented toward medium size enterprises.

4. Deregulation. Another measure that has been adopted by governments in the region has been the deregulation of the financial system. The aim of this policy was to encourage banks to lend to SMEs at what has been called the equilibrium rate. Unfortunately, liberalization alone could not help the development of SMEs in the absence of technological capabilities and in an environment characterized by underdeveloped skills, institutions and support systems. In this case, financial deregulation has been detrimental to SME development, due to the lack of supportive measures which would have allowed a better access to the formal financial system.

Development banking refinancing and supporting measures have been able to reach a larger group of SMEs, through what has been called "política de masificación del crédito". The most important experience has been that of Nafin (Mexico) that in the period 1990-1994 increased the size of their associated SMEs from 6.5 to 127 thousand enterprises. In all referred countries there has been a larger number of SMEs associated to the credit mechanism.

Countries have been encouraged by multilateral institutions to evaluate these policies. A World Bank report (Report No. 9530 published in 1991- including different regions and countries - Ecuador and Mexico among them) concludes that "there are grounds for optimism that SME and associated TA can make an important contribution to growth with equity. The considerations that led the Bank to move into this area seem vindicated. The projects have been successful in promoting SME expansion and efficient employment creation at good economic and financial rates of return and are likely to be relatively effective contributors to poverty alleviation. The anticipated flow of credit to the target group of borrowers has been achieved and expectations with respect to the capacity of the participating institutions have been fulfilled. The magnitude of

resources transferred by the Bank and by the intermediaries to the subborrowers has been significant, although in relation to total credit flows it remains fairly small. In at least one country, Bank credit replaced credit from other sources so that there was no net positive effect. In others, the total flow rose markedly as a result of the projects. SME lending remains heavily concentrated in a few economically dominant areas despite efforts at dispersion. Unless efforts are also made to decentralize government, banking and technical services, serious handicaps to wider dispersion will remain".

B. What is the basic problem?

Results show that taking into consideration size per se doesn't help development. Money alone will not ultimately assure economically viable small firms. Effective social organization - that is, rooting small business in a cooperative social network and tying to it social relations - appears to be more important for their competitiveness. Monetary assistance, such as tax exemptions, may produce the undesirable employment instability. This might occur if the financial assistance entices more people to establish firms which lack competence and the financial stamina to sustain themselves in the long run.

What is required is to solve the value added trap, which has created a poverty circle. From the above discussion, one of the mechanisms to do so will be to foster subcontracting relations with large firms. In place of state support, it may be more productive if large enterprises lend support to the economic existence or subsistence of small firms. These organizations can transfer various kinds of resources to small ones, such as financial resources, technical know-how, equipment, materials, and human resources. To the extent that the large firm makes such investments, it will develop an interest in the continuity and stability of small firms, and a longer term co-operative relation may emerge (Sengenberger, Loveman and Piore 1990).

Mexico and Brazil reports show that subcontracting improves the operation of small firms. One of the main benefits of SME-subcontracting is that a contract could ensure a regular cash flow, which forms the basis of long term accumulation. This is better than access to the banking system on a non regular basis. From that point of view, a strategy that could benefit SME cash flow will help to assure accumulation and it could also help to improve the level of income. Subcontracting could also help SME access to the financial group associated with large firms, solving that way the problems of accessibility that these firms usually had to face.

C. How to reform the financial system as to improve access of SME?

Grouping informal sector institutions or a Micro-enterprises bank. Informal intermediaries had been helpful for day to day operations of SMEs, but their impact on overall operations is small. One way to improve the efficiency of this network could be to promote the cooperation among small intermediaries at a local, regional or national level to constitute intermediate financial institutions. A success story is Taiwan, where small intermediaries were pushed to form the Medium Business Bank, increasing the size of their operations and reducing costs of intermediation. In Latin America, governments had been unable to take advantage of what can be called popular financial networks. If they got acquainted with this market and promote grouping, this could be a costless way to increase the institutional framework, without getting into a large process of institutional development.

Some countries have studied the way to promote grouping and develop a bank from the informal sector. For Colombia, Parra (1993) in a research paper for PREALC prepared a simulation analysis of grouping non-governmental organization, in order to constitute the informal sector bank. Castro (1993) outlines the same proposal for Peru, departing also

from non-governmental organizations. In Mexico, the InterAmerican Development Bank prepared a proposal for the creation of a Bank for the Small Businesses (1992).

The idea that Latin American countries have to promote is that financial intermediaries have to be close to the client location, otherwise bureaucratic processes develop, costs increase, and SMEs access to finance is denied. The region has been able to develop national financial institutions, but has lacked the opportunity to develop efficient regional intermediation that could help improved access to financing by SMEs. Thus, the reform should focus on developing more efficient local intermediaries, rather than tolerating the existing situation in the informal financial market.

BIBLIOGRAPHY

Adams Dale and Fitchett Delbert. Informal Finance in Low-income Countries. Westview Press, 1992.

ALIDE El Progreso Económico y Social Latinoamericano y la Nueva Agenda del Financiamiento del Desarrollo. Lima, Perú Julio 1994.

Asociación Latinoamericana de Instituciones Financieras de Desarrollo. Liberalización Financiera y Banca de Desarrollo. Perú, 1993.

Banco Central de Bolivia. Informe Anual, 1993.

Banco Central de Chile. Boletín Mensual, Julio de 1993.

Banco Central de Colombia. Informe anual 1993.

Banco Central del Ecuador. Cuentas Nacionales del Ecuador, 1969-1992.

Banco Central del Ecuador. Memoria Anual, 1992.

Banco de México. The Mexican Economy, 1994.

Banco Interamericano de Desarrollo. Progreso Económico y Social en América Latina, Informe 1993. Tema Especial Recursos Humanos Washington 1993.

Bancomext. Apoyo Financiero y Promocional para la pequeña y mediana empresa Enero 1993.

Berger Marguerite, Buvinic Mayra. La Mujer en el Sector Informal, Trabajo Femenino y Microempresa en América Latina. Quito, 1988.

Berry Albert, Cortes Mariluz. On the Dynamism of Small and Medium Industry in Colombia: Some Possible Lessons. The Open Policy, 1990.

Berry Albert. Methodological Complexities in Relating Firms or Plant Size to Economic Efficiency. Off print From Industry and Development, No. 33.

Berry Albert. Small and Medium Business Under Trade Liberalization: Canadian and Latin American Experiences and Concerns. IDC-ECLAC project. Toronto, 1992.

Bianchi Andrés, Adolfo Diz, Catherine Mansell and Felipe Morris. Reformas y Reestructuración de los Sistemas Financieros en los Países de América Latina. CEMLA, 1994.

Bolsa Mexicana de Valores. Anuario Financiero 1993.

CEPAL. América Latina y el Caribe, Políticas para mejorar la inserción en la economía mundial. Santiago de Chile 1994.

CEPAL. El Financiamiento de la pequeña y Mediana Industria. CEPAL/ONUDI 1992.

Floro Sagrario, Yotopoulos Pan. Informal Credit Markets and the New Institutional Economics, The Case of Philippine Agriculture. Westview Press, 1991.

Gatto Francisco, Ferraro Carlo. Las PYMES en el Mercosur. CEPAL, Argentina, 1993.

Glen Jack, Pinto Brian. Debt or Equity? How Firms in Developing Countries Choose. International Finance Corporation, Discussion Papers No. 22. 1994.

Glen Jack. How Firms in Developing Countries Manage Risk. International Finance Corporation. Discussion Papers No 17. 1993.

IMF International Financial Statistics. Volume XLVII Number 12 December 1994.

International Finance Corporation. Emerging Stock Markets, Fact book, 1994.

International Finance Corporation. Financing Corporate Growth in the Developing World. Discussion Papers No. 12, 1991.

Kagami M., Schwartz Gilson. An industrial Survey on micro and small enterprises in Brazil. July 1992 Mimeo.

Kagami Mitsuhiro. Trade Blocks and Strategies for Small-scale Enterprises. Institute of Developing Economies, Japan, 1994.

Lanusse Jose Antonio. Diagnóstico de la Pequeña y Mediana Industria en el Ecuador. BID, 1993.

Laserna Roberto. La Pequeña y Mediana Empresa en Bolivia. CDERES. Bolivia, 1993.

Lawton Helen, Dickson Keith, Lloyd Stephen. There are Two Sides to Every Story, Innovation and Collaboration Within Networks of Large and Small Firms. Research Policy No. 20, 1991.

Levy Brian. Obstacles to Developing Small and Medium-sized Enterprises. World Bank, Working Papers, 1991.

Little Ian, Mazumdar Dipak and Page John. Small Manufacturing Enterprises. A Comparative Analysis of India and Other Economies. World Bank, 1987.

López Espinoza. Mario. El Financiamiento de la Pequeña y Mediana Empresa en América Latina. CEPAL-PMUD, 1994.

Machicado Saravia Flavio. Sistema Financiero y Reactivación. Bolivia, 1989.

Mezzera Jaime. Crédito Informal: Acceso al Sistema Financiero. PREALC, OIT, 1993.

Ministerio de Economía, Chile. Programa de Apoyo a la Pequeña y Mediana Empresa, Informe 1992-1993.

Morales Rebeca. Small Enterprises in Industrialized Countries: Implications For Latin America. The Claremont Graduate School. Mimeo.

Morris Felipe, Mark Dorfman, Jose Pedo Ortiz and Franco Maria Claudia. Latin America's Banking Systems in the 1980's. A cross-country comparison. World Bank Discussion Papers No. 81, 1990.

Padilla Lira Arturo. Estudio Sobre la Pequeña y Mediana Empresa Industrial de Guatemala. CEPAL-Mexico, 1994.

Unidad de Desarrollo Industrial, CEPAL. Encuesta a la Pequeña y Mediana Empresa Industrial, Guatemala, 1993.

Pfeffermann Guy, Madarassy Andrea. Trends in Private Investment in Developing Countries 1993. International Finance Corporation, Discussion Papers No.16, 1992.

Picciotto R. The Future of Development Finance Institutions. Presented at the seminar for chief executives of development finance institutions. World Federation of Development Finance Institutions. Madrid, 1994.

PREALC. ElCrédito Informal en Bogota. Cali y Medellin. OIT, 1990.

PREALC. Lecciones Sobre Crédito al Sector Informal. OIT, 1990.

Quintero Victor Manuel. Alternativa Microempresarial. Universidad de San Buenaventura, Colombia 1989.

Revista de Comervio Exterior. Reformas y perspectivas del sector financiero mexicano.

Roe Alan, Bruck Nicholas, Fedder Marcus. International Finance Strategies for Developing Countries. Economic Development Institute of the World Bank. Policy Seminar Report No.31, 1992.

Ruiz Durán Clemente. Economía de los Pequeños Empresa. Hacia una Economía de Redes como Alternativa Empresarila papa el Desarrollo. Ariel, 1995.

Salinas de Gortari Carlos. Sexto Informe de Gobierno, 1994.

Salinas de Gortari. Sexto Informe de Gobierno 1994 Anexo Poder Ejecutivo Federal. EUM, 1994.

Samaniego Pablo, Maiguashea Lincoln. Situacion y Perspectivas de la Micro y Pequeña Industria en Cinco Ciudades Secundarias de la Costa Ecuatoriana. INSOTEC. Quito, 1989.

Sanchez U., Fernández Perez Mota E. La política industrial ante la apertura. Secofi, Nacional Financiera y FCE. México, 1994.

Schwalbach Joachim. Small Business Dynamics in Europe. Small Business Economics, Vol.6, 1994.

Secretaría de Hacienda y Crédito Público. Ahorro y Crédito en Poblaciones Semi-Urbanas y Rurales. México, 1993.

Secretaría de Hacienda y Crédito Público. Encuesta Sobre Sistemas Financieros en Poblaciones Semi-Urbanas y Rurales. México, 1994.

Secretaría del Trabajo y Previsión Social. El Sector Informal en México. Cuadernos del Trabajo 2, 1993.

Shieh G.S. Boss Island, The subcontracting Network and Micro-Entrepreneurship in Taiwan's Development. American University Studies, Peter Lang, 1992.

Silva-Herzog F. Hesus, Leucona Ramon. Banca Central en Améerica Latina: El Financiamiento Interno del Desarrollo. CEMLA, Banco de México, 1994.

Singh Ajit. Asian Economic Success and Latin American Failure in the 80's: New Analyses and Future Policy Implications. International Review of Applied Economics, Volume 7, Number 3, 1993.

Singh Ajit. The East Asian Miracle: Where do we Stand in 1994?, Paper presented at the conference Economic Growth and Long Term Development. World Bank, University of Madrid, UNCTAD, ECLA, 1994.

Singh Ajit. The Stock-Market and the Economic Development: Should Developing Countries Encourage Stock-markets? UNCTAD Review, 1993, No.4.

Sorensen Mosquera Pedro. La Corporación Andina de Fomento: Una Institución Financiera de Servios Múltiples. Presented at the seminar "La Banca de Desarrollo Hacia el Siglo XXI", UNAM, 1994.

Spath Brigitte. Small Firms and Development in Latin America. International Institute for Labour Studies, 1993.

Standing Guy, Tokman Victor. Towards Social Adjustment. ILO, 1991.

The Economist. Third-World Finance. The Economist, September 25th-October 1st, 1993.

Vanni Raniero. Un Programa Integrado Para Movilizar el Potencial de Crecimiento y de Empleo de las PYME. La Europa sin Fronteras. Julio/Agosto 1994.

World Bank. Colombia. Industrial Restructuring and Development Project. Staff Appraisal Report, 1991.

World Bank. Financial Systems and Development. Policy and Research Series No.15, 1990.

World Bank. World Bank Support for Small and Medium Industry in Selected Countries, 1991.

Annex 1

What is small?

Country	Definition		Source
	Size by number of employees	Second definition: by sales, net income, income, assets, productive, assets and capital (national currency)	
Argentina	Micro: less than 15 Small: between 16 and 50 Medium: between 51 and 200 Large: more than 200	Micro: total sales less than US$200000 Small: between 200000 and 1260000 Medium: between 1260000 and 12800000 Large: more than 12800000 Micro: productive assets less than US$100000 Small: productive assets between 100000 and 600000 Medium: between 600000 and 4400000 Large: more than 4400000	Las PYMES en el MERCOSUR, CEPAL, Francisco Gatto, 1993. 1. Just for the industrial sector.
Bolivia	Micro: less than 5 Small: between 5 and 49 Medium: between 50 and 99 Large: more than 100		Brigitte Spath, Small firms and development in L.A., International Institute of Labor Studies.
Brazil	Micro: less than 19 Small: between 20 and 99 Medium: between 100 and 499 Large: more than 500	Micro: Net income less than US$130000 Small: net income between 130000 and 1300000 Medium: net income between 130000 and 4000000 Large: more than 4000000	Las PYMES en el MERCOSUR, CEPAL, Francisco Gatto, 1993. 1. SEBRAE. 2. For financial purposes (financial institutions).
Colombia	Micro: less than 10 Small: between 10 and 49 Medium: between 50 and 199 Large: more than 200		Pinto y Arango. La pequeña y mediana industria en Colombia.
Chile	Micro: between 1 and 9 Small: between 10 and 49 Medium: between 50 and 200 Large: more than 200	Micro: Total sales than $60000 Small: between $60000 and $600000 Medium: between $600000 and 1200000 Large: more than $1200000	Programa Nacional de Apoyo a la pequeña y Mediana Empresa, 1992-1993, Ministerio de Economia. 1. Is not an official classification. Just for analytical purposes.
Ecuador	Micro: less than 10 Small: between 10 and 49 Medium: between 50 and 99 Large: more than 100	Micro: with assets (excluding land and buildings) less than US$6,000 Small: less than US$52,000	1. Just for some institutes and financial institutions. 2. Coorporación financiera Nacional. 3. Ley de Fomento a la pequeña Industria y Artesania. (Micro is not included).
Guatemala	Micro: between 2 and 8 Small: between 5 and 19 Medium: between 20 and 50 Large: more than 50	Micro: with total capital between US$338 and US$5932 Small: between US$338 and US$12711 Medium: between US$847 and US$33898 Large: more than US$33898	CEPAL, La pequeña y Mediana empresa en Guatemala. Arturo Padilla, 1994. There are more than one source. In some cases the micro industry is a subgroup of the small industry.
Mexico	Micro: less than 15 Small: between 16 and 100 Medium: between 101 and 250 Large: more than 250	Micro: annually net sales less than N$900,000 (US$180,000) Small: less than N$9,000,000 (US$1,800,000) Medium: sales less than N$20,000,000 Large: sales less than N$20,000	Secretaria de Comercio y Fomento Industrial. Diario Oficial del 3 de diciembre de 1993.
Peru	Craft: less than 4 (familiar) Small: between 5 and 19 Medium: between 20 and 199 Large: more than 100		Fernando Vallarán. Small scale industry and efficiency groups in Peru. Small firms and development in L.A., International Institute of Labor Studies.
Uruguay	Micro: less than 4 Small: between 5 and 19 Medium: between 20 and 99 Large: more than 99	Micro: total sales less than US$60000 Small: between 60000 and 180000 Medium: between 180000 and 1000000 Large: more than 1000000 Micro: total assets less than US$20000 Small: between 20000 and 50000 Medium: between 50000 and 350000 Large: more than 350000	Las PYMES en el MERCOSUR, CEPAL, Francisco Gatto, 1993. The companies have to fulfill the three parameters for being classified.

Annex 2

Distribution of industrial enterprises by size in selected L.A. countries	*Micro*	*Small*	*Medium*	*Large*	*Total*
Colombia (a) 1990	89,0	6,2	4,1	0,7	100,0
Chile (b) 1992	83,2	14,1	1,2	1,5	100,0
Brazil (c) 1985	82,3	13,1	4,0	0,5	100,0
Peru (d) 1987	87,6	10,8	1,5	0,1	100,0
Guatemala (e) 1993		66,4	26,1	7,6	100,0
Ecuador (f) 1989		67,1	16,3	16,6	100,0
Bolivia (g) 1992	87,2	8,3	2,3	2,3	100,0
México (h) 1994	91,8	6,2	1,2	0,9	100,0

Sources and definitions
a) Colombia: CEPAL Las Pymes en el mercosur. Micro 0-10; small 10-49; medium 50-199; large >200 employees
(b) Chile Ministerio de Economia Micro 0-9; small 10-49; medium 50-200; large >200 employees; *small data includes medium industry
(c) Brazil Small firms in Latin America Micro 0-19; small 20-99; medium 100-499; large >500 employees
(d) Peru Small firms in Latin America Micro 0-4; small 5-19; medium 20-199; large >200 employees
(e) Guatemala CEPAL La Pequeña y mediana empresa industrial de Guatemala Micro 2-8; small 5-19; medium 20-50; large >50 employees
(f) Ecuador BID Diagnostico de la Pequeña y Mediana Industria en el Ecuador Small 10-49; medium 50-99; large >100 employees
(g) Ceres La Pequeña y Mediana empresa en Bolivia Micro 1-4; small 5-15; medium 15-29; large >30
(h) INEGI Censos Economicos 1994 Micro 0-15; small 16-100; medium 101-250; large >250

Annex 3

Distribution of industrial employment by size in selected L.A. countries	*Micro*	*Small*	*Medium*	*Large*	*Total*
Colombia (a) 1990	22,2	24,4	16,3	37,1	100,0
Chile (b) 1992*	43,3	36,5		20,2	100,0
Brazil (c) 1985	17,6	23,6	36,9	21,9	100,0
Peru (d) 1987	52,2	19,0	16,0	12,8	100,0
Guatemala (e) 1993		35,0	12,0	53,0	100,0
Ecuador (f) 1989		20,5	15,5	64,0	100,0
Bolivia (g) 1992	31,5	13,1	11,1	44,3	100,0
México (h) 1994	20,5	19,9	15,3	44,4	100,0

Sources and definitions
(a) Colombia: CEPAL Las Pymes en el mercosur. Micro 0-10; small 10-49; medium 50-199; large >200 employees
(b) Chile Ministerio de Economia Micro 0-9; small 10-49; medium 50-200; large >200 employees; *small data includes medium industry
(c) Brazil Small firms in Latin America Micro 0-19; small 20-99; medium 100-499; large >500 employees
(d) Peru Small firms in Latin America Micro 0-4; small 5-19; medium 20-199; large >200 employees
(e) Guatemala CEPAL La Pequeña y mediana empresa industrial de Guatemala Micro 2-8; small 5-19; medium 20-50; large >50 employees
(f) Ecuador BID Diagnostico de la Pequeña y Mediana Industria en el Ecuador Small 10-49; medium 50-99; large >100 employees
(g) Ceres La Pequeña y Mediana empresa en Bolivia Micro 1-4; small 5-15; medium 15-29; large >30
(h) INEGI Censos Economicos 1994 Micro 0-15; small 16-100; medium 101-250; large >250

Annex 4

Value added, sales or income by firm size
Share (percentage)

Country	*Definition*	*Micro*	*Small*	*Medium*	*Large*	*Total*
Colombia (a) 1990	Total income	7,8	22,4	14,9	54,9	100,0
Chile (b) 1992	Total sales	4,9	13,9	6,9	75,2	100,0
Brazil (c) 1985	Value added	5,0	17,0	41,0	36,0	100,0
Peru (d) 1987	Value added	13,0	13,0	28,0	46,0	100,0
Ecuador (e) 1989	Value added		12,7	15,2	72,1	100,0
Bolivia (f) 1992	Value added	8,7	2,1	3,8	85,5	100,0
México (g)	Net income	9,0	12,9	12,6	65,4	100,0

Sources and definitions
(a) Colombia: CEPAL Las Pymes en el mercosur. Micro 0-10; small 10-49; medium 50-199; large >200 employees
(b) Chile Ministerio de Economia Micro 0-$60 mil;small $60 mil-$600 mil; medium 5$600 mil-1.2 mil; large > 1.2 million
(c) Brazil Small firms in Latin America Micro 0-19; small 20-99; medium 100-499; large >500 employees
(d) Peru Small firms in Latin America Micro 0-4; small 5-19; medium 20-199; large >200 employees
(e) Ecuador BID Diagnostico de la Pequeña y Mediana Industria en el Ecuador Small 10-49; medium 50-99; large >100 employees
(f) Ceres La Pequeña y Mediana empresa en Bolivia Micro 1-4; small 5-15; medium 15-29; large >30
(g) INEGI Censos Economicos 1994 Micro 0-15; small 16-100; medium 101-250; large >250